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THE AMERICAN ECONOMY, KEYSTONE OF WORLD PROSPERITY

A SERIES OF ADDRESSES AND PAPERS PRESENTED AT THE ANNUAL MEETING OF THE ACADEMY OF POLITICAL SCIENCE
NOVEMBER 5, 1953

EDITED BY
DUMAS MALONE

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PREFACE

THE supreme importance of the American economy is fully recognized on both sides of the Iron Curtain. The Communist imperialists in the Kremlin have based fond hopes on an American depression, which they have long and vainly predicted; and the mere mention of one sends cold chills down the spines of the leaders of the free world, in any country. Thus the strengthening and preserving of the American economy has become a supreme task of statesmanship. The continuance of civilization itself is contingent on our economic health.

These are truisms, but the topic resolves itself into any number of practical questions—some more immediate than others, but all complex and difficult. It is with these intensely practical matters—debt, taxes, trade, labor, and the like—that the speakers at the fall meeting of the Academy of Political Science concerned themselves. More questions can be asked than can possibly be answered even by such men as these, but their thoughts well deserve presentation to a larger audience.

Hence we present these Proceedings, expressing at the same time to the participants in the meetings the deep appreciation of the officers of the Academy for their contributions.

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PART I

THE FEDERAL TAX SYSTEM: SOURCE OF STRENGTH OR WEAKNESS?

INTRODUCTION

JOEL DEAN, *Presiding*
Professor of Business Economics, Columbia University

IT is my privilege to open the 73rd Annual Meeting of the Academy of Political Science. Carrying on its long tradition of analysis of vital issues of practical public policy by distinguished experts, the Academy presents this morning an examination of impacts of the federal tax system by a business man, an academician and a lawyer.

Our first speaker is Mr. Beardsley Ruml. He will talk about "Federal Budget Reform and Taxes". To find a subject more topical, more complex and more controversial would be difficult. To find a man better qualified to discuss it would be impossible. Mr. Ruml is one of those rare free spirits who have ranged widely and achieved great distinction in a dismaying variety of careers. Though nominally and initially a business man, he was at a tender age Dean of the Social Science Division of the University of Chicago. Shortly thereafter he was reincarnated as Treasurer of R. H. Macy and Company and was later Chairman of the Board of Directors. He has also been Chairman of the Board of the New York Federal Reserve Bank. At present he is a consultant and a director of a large number of companies.

But perhaps his most lasting imprint on our civilization is in the field of federal tax and fiscal policy. In tax reform, what he has advocated—the Ruml Plan—stands now as a historic achievement. In budget reform, what he advocates today will, I hope, have parallel success. It gives me great pleasure to present to you Mr. Beardsley Ruml.

REMARKS

MR. BEARDSLEY RUML: Mr. Chairman, Ladies and Gentlemen: I have a short title for this address, I simply call it "Budget Reform—Round Two". I am not sure that it is dignified enough for printing in an Academy publication, but nevertheless that is what it will be known as, as far as we are concerned.

BUDGET REFORM—ROUND TWO

BEARDSLEY RUML

THREE months ago, on August 12, 1953 to be exact, I testified before the Ways and Means Committee which was conducting hearings on federal excise taxes. I testified that, with the usual exception of the excises on alcohol, tobacco and gasoline, the discriminatory selective excise taxes should and could be completely dropped, and that no new taxes, retail sales tax or manufacturers excise or other tax, are necessary to take their place. The reason is simply this, the *net* loss to the Treasury from the elimination of the selective excises referred to above is $3,400,000,000, and the present system of federal financial record keeping, the miscalled "budget", overstates by $12 billion annually the need for tax revenue.

Since I gave this testimony last August, these figures have never been challenged, so far as I know, except in one respect. It has been pointed out to me that the figure I used for atomic energy installations includes some purely military items and is therefore too high by about $1 billion. On the other hand, within the military there are a number of offsetting items of continuing capital value, real estate, convertible buildings and the like. So for practical purposes, and subject to correction based on future critical analysis, I feel that we can hold to our figure of $12 billion as representing current overstatement of annual tax requirements; and that therefore, with budget reform, the tax reduction policy contemplated by law and herein proposed is both desirable and realistic.

Incidentally, the federal budget for 1954 included $26.6 billion for "Additions to Federal Assets". The amounts involved, says the Budget Message, are additions to the type of assets which, under private accounting practice, would normally appear on a balance sheet. In the federal budget the whole $26.6 billion is included as current expense. However, the figure which I have used is much smaller, that is a total of $6 billion, since under this proposed budget reform I include as assets only revenue-producing and revenue-receiving assets that can earn their interest and amortization; and commodities and articles intended for resale, after allowing for storage, depreciation and other costs.

Although the amount of $12 billion seems, therefore, to be acceptable as a reasonable figure, there is nevertheless sharp difference of opinion as to whether we should undertake a budget reform program that would so reduce the tax requirements for budget balance. There has been strong support for this program in legislative and business circles and in the press. The Administration's attitude has been negative, but only mildly so, since during the past three months some of the suggested changes have already been made under the pressures of the ill-advised ceiling on the federal debt limit. There also have been some unfavorable editorials, mostly in smaller communities in the South and Southwest and also in a few larger cities, such as Detroit and St. Louis.

Obviously we need a federal budget reform program; and, with budget reform, not only can the selective excises be abolished, but all other tax reductions now written into law can proceed as intended by the Congress. The reductions in the individual income tax can proceed; so also the elimination of the excess profits tax; the reduction of the corporation profits tax from 52 per cent to 47 per cent; and the return of excises on tobacco, alcohol and gasoline to the level from which they were raised in 1951.

The overstatement of the need for tax revenue of $12 billion annually for fiscal 1954 is composed of four principal parts as follows:

1. Reductions made possible by efficiency and economy	$ 2 billion
2. Capital items improperly included as expense	2 billion
3. Investments that could be organized as self-financing authorities	4 billion
4. Result of going on a consolidated cash budget	4 billion
	$12 billion

I shall discuss each of these four items in detail, but briefly.

First. Reductions made possible by efficiency and economy. I have included this item to indicate that I favor efficiency and economy to the maximum extent consistent with the national interest. I have placed the figure as low as $2 billion so that there can be little dispute that such a figure can be attained by sensible economy measures. If even larger reductions in tax

requirements can be made by efficient economy, it would be desirable from every point of view to do so.

Second. Capital items improperly included as expense. These capital items are of two kinds. (a) There are those disbursements that result in the acquisition of revenue-producing assets. The most conspicuous of these are the F.N.M.A. mortgages, of which the federal government now holds $2,250,000,000. And there are other similar holdings such as RFC, small business and rural electrification loans. (b) In a different class of capital assets are purchases intended to be resold under appropriate circumstances. Disbursements for the stockpiling of strategic materials are of this class. To be sure, any expenses of storage and deterioration are current expense items; but the cost of acquisition is not. Lending and spending for the holding of agricultural surpluses should be similarly considered.

Third. Investments that could be organized as self-financing "authorities". Some may not like the term "authorities", but it has been made meaningful and respectable by the conspicuous success of self-financing authorities in many states and cities, for example New York and Pittsburgh.

Two general classes of authorities may be distinguished: those that derive their income from charges of one kind or another from the public using the facilities; and those that might receive currently by lease or by contract from the appropriate department of the federal or local government the revenues necessary to cover costs of operation and annual financial charges for interest and amortization. Included in the latter class of authorities could be real estate purchases, construction of productive government buildings, and investment in atomic energy plants for the production of plutonium. The Defense Department buys oil on a contract basis; why shouldn't it buy plutonium?

Few would dispute the businesslike principle that truly producing assets should be capitalized, and that the benefits realized from these assets should be paid for as they are consumed. The financing of authorities on a self-financing basis will, of course, necessitate a rate structure appropriate to the costs. But there is no logic in forcing this year's taxpayer to pay for benefits to go without cost to future taxpayers for years to come.

My estimate for authorities is $4 billion annually. But I believe that a conscientious and imaginative study of the op-

portunities for reclassification of expense would result in time in a figure even higher than the $4 billion suggested.

I am well aware that the treating of capital items and authorities separately is susceptible to abuse and I would limit such treatment strictly to the two obvious categories of assets which I have just specified.

Fourth. The result of going onto a consolidated cash budget. This would reduce by $4 billion the apparent federal requirements for tax revenue. This change has been recommended for years by students, organizations, and government agencies—among them, the Committee for Economic Development, the Council of Economic Advisers, and the 1949 Senate Sub-Committee on Monetary and Fiscal Policy, headed by Senator Douglas. The change has the support of persons in both parties. It is unfortunate that the change was not made with the beginning of the new fiscal year which has just started; but I see no insuperable difficulties about making the change-over at any time, say January 1, 1954.

The most comprehensive attack on these budget reform proposals was made by Senator Harry Byrd in a letter to Chairman Reed of the Ways and Means Committee. It is my purpose to answer, to the extent that time permits, Senator Byrd's communication, since in doing so I will have also met most of the objections of others that have come to my attention.

With respect to going onto a consolidated cash budget, Senator Byrd disagrees. The desirability of going onto a consolidated cash budget in order to bring in the operations of social security is so generally recognized at the present time, as a result of technical studies and practical observation over the past decade, that for those who, like Senator Byrd, still hold the opposite opinion no brief exposition of the subject would be persuasive. I only refer here to the recent Policy Statement of the Committee for Economic Development of April 1953. In this Statement it is explained, "CED's main reason for using the cash budget is that it gives a better indication of the inflationary or deflationary effects of Federal finances." This is the important consideration in analyzing the need for taxes.

The current social security surplus should be brought out into the open where it can be seen, and where it can be the subject of public discussion and public policy. And that is exactly

what would happen with the adoption of a consolidated cash budget.

The accumulating reserves in the social security and other federal retirement accounts must be restored to investment and employment if we are to avoid depression. We cannot withdraw between $3 billion and $4 billion a year, year after year, from the people's income without restoring it in appropriate ways to the flow of purchasing demand.

As for the present social security payments as a burden on individuals, they are now far less than would be required if the social security reserves were to be built up to a true actuarial basis. Accordingly, the individual receives in the present value of future benefits much more than the amount of his contribution and that of his employer. There would appear to be no reason why these rates should be reduced now in view of the government's commitment to social security payments. On the other hand, social security rates cannot be put on a true actuarial basis without putting the government far more into the total economy than has ever been responsibly contemplated.

Senator Byrd objects to the budgetary treatment of capital and investment items, even when carefully defined, so as to separate them from ordinary current expense. He calls such treatment "a combination of threadbare budgetary subterfuges which were originated as ideas by New Dealers over the past twenty years, but cast aside, even by them, as too phoney or too misleading for serious consideration." On this point, Senator Byrd's comments are irrelevant and uninformed.

They are irrelevant because the validity of a principle of budgetary accounting cannot be affected by New Deal sponsorship nor by New Deal opposition. We might judge the New Deal by its attitude on a principle or program, but hardly the program itself. Certainly Senator Byrd would consider it irrelevant to judge the validity of his own present position by observing the fact that he finds himself associating with the budgetary ideas and policies of former Secretaries Morgenthau and Snyder, with respect to including capital items and excluding social security from the operating accounts of the government.

But worse than irrelevant, Senator Byrd's comments are uninformed. It was President Hoover who in December 1931 recommended to Congress the creation of the largest self-financing

corporation of the federal government, the Reconstruction Finance Corporation. The RFC was regarded by President Hoover as capital in character. Except for its original stock of $500 million, its lending and borrowing operations were not included within the framework of the expenditure budget of his administration.

The creation of the RFC was recommended in 1931 to President Hoover by a bipartisan, indeed a nonpartisan, group, including Governor Eugene Meyer of the Federal Reserve Board, Andrew Mellon, Secretary of the Treasury, Odgen Mills, Under Secretary of the Treasury, and Senator Walter F. George. The Senate Banking and Currency Committee, before which the Reconstruction Finance Corporation legislation was thoroughly debated, included men of outstanding financial capacity such as Senator Couzens and Senator Glass. The first RFC Chairman was Eugene Meyer, and its President was General Charles G. Dawes. Members of its first board included Harvey Couch and Jesse Jones. A group less characteristic of the yet unborn New Deal to which Senator Byrd refers could hardly have been found.

The Reconstruction Finance Corporation was established as a self-financing institution, authorized to issue its own debentures. Under Secretary Mills explained to the Senate Banking and Currency Committee why the Hoover Administration wanted such a separate financing corporation. On December 19, 1931, Under Secretary Mills was closely questioned by Senator Bulkley. The questions and answers have more than historical relevance to the present discussion. And I am setting forth a few paragraphs as an illuminating commentary on the thinking at that time.

> Senator Bulkley. What is the advantage of raising these funds through corporation debentures rather than by a direct issue of bonds by the Treasury, which would be easier for the public to understand?
>
> Under Secretary Mills. Oh, I think it is much wiser to do it through an independent corporation rather than to have a direct obligation of the government . . .
>
> I think you can create a business entity that will deal with a particular problem which is essentially a banking problem. I should hesitate a great deal before I intrusted this whole job of loaning Government funds directly and turning the Treasury of the United States into a glorified bank.

> . . . frankly I would much rather see this corporation issue its own debentures than to confuse it with our public-debt operation. In the matter of accounting and presenting an accurate picture, I think the accounts of this institution should not be merged with the public-debt accounts of the United States Government.
>
> Senator Bulkley. I see no particular reason for merging; but, if the Government is on these obligations as a guarantor, is it obligated the same as if it were its own direct obligation?
>
> Under Secretary Mills. Not quite; but, supposing we were obliged to furnish a billion dollars, the public debt would go up a billion dollars. I think it would give you a distorted picture of the public debt, because presumably all of those funds would have been loaned on good collateral, and it, therefore, would be an entirely different form of public debt than the one which is outstanding today and which represents, generally speaking, war costs and current deficits. It has always seemed to me that it is not only essential to keep all public accounts in absolutely accurate form—that goes without saying—but equally essential to keep them in readily understandable form so that the average man, if he is interested, can find out just what the Government owes and what its financial situation is.

The bills creating the Reconstruction Finance Corporation were passed by Congress by a vote of 63 to 8 in the Senate and 335 to 56 in the House, and the Reconstruction Finance Corporation commenced its operations on January 22, 1932. Toward the end of the year, on December 7, 1932, President Hoover, in a message to Congress on the budget said: "The authorization of large programs of self-liquidating public works to be financed by the Reconstruction Finance Corporation provides aid to employment . . . without burden upon the taxpayers."

Long before this, in 1916, the Federal Land Banks had been established under a Democratic Administration as federally-owned, self-financing corporations. Their purpose was to provide long-term mortgage credit to farmers. Here too, except for the initial capital stock, the policy was to exclude items that were capital in character from the regular operating accounts of the government.

Senator Byrd and I seem to agree. To repeat his own words, "I am for constructive budgetary reform to bring about more disclosure of the purposes for which the federal government is spending and taxing." Where we differ is on important questions of policy and method.

Senator Byrd says, "The Ruml proposal would set back budgetary disclosure twenty years." The fact is that my proposals would set federal budgetary disclosure back twenty-one years, back to the days of Senator Glass, Ogden Mills, Secretary Mellon and President Hoover. Twenty years ago, in 1933, a detour was made, protested unsuccessfully by many New Dealers, a detour from the straight road of businesslike public finance and public accounting into a morass of budgetary confusion in which we now find ourselves, and which has already done incalculable harm.

Senator Byrd refers to my interest in the discriminatory selective excises in a manner calculated to imply insincerity on my part in the cause of budget reform. True, I am interested in removal of selective excises, and, since the particular hearings at which my testimony was given were on the subject of selective excises, I started from that point. I stated that, since the present budget overstated tax requirements by $12 billion, most of the selective excises could be removed under a realistic budget reform program and that no general sales tax or manufacturers excise tax would be required to take their place.

But I am equally persuaded that a lower personal income tax and a lower corporation profits tax would also be in the national welfare. And I am interested in them, too.

I am interested in efficient economy that will not cripple the vital constructive and protective functions of the federal government.

And I am interested that savings and pension allowances will not be diluted by inflation.

Starting from any of these interests, one moves inescapably to the necessity of a budget reform program that will permit lower taxes, *and* the maintenance of essential expenditures, *and* the protection of the currency by making possible a balanced budget at high levels of employment.

Since I testified before the Ways and Means Committee, the Administration has taken steps to expand the financing of loans involved in connection with the Commodity Credit Corporation's price support program separately from the regular operating accounts of the government. On September 25 the Department of Agriculture announced that, "in view of the heavy crops to be financed through such loans this fall, the program is intended

to achieve maximum investment of private funds in CCC crop loans, thus relieving the United States Treasury as much as possible of a financial burden which would have to be taken care of through public borrowing. . . . Certificates of interest will be offered for the first time in connection with CCC grain and other commodity loans, an extension of a practice already in effect on cotton loans." This expanded financing outside the regular government accounts through private banks by certificates of interest is now Administration policy. There is clearly no subterfuge. All the facts are disclosed to the Congress and to the public. A more logical approach to the CCC problem has been made. This particular example illustrates the point that I made to the Ways and Means Committee, namely, that under certain specified circumstances separate financing to carry a capital investment in inventory loans is desirable, straightforward and in the public interest.

The question will occur to many—where will the money come from to pay for the capital items to be excluded from the budget and for the investment needs of the various authorities? The answer is that the money will come from the same sources as it comes from today, that is, as borrowings from commercial banks, from savings institutions and from the public. The difference would be that the borrowings would be associated in general, and in many cases specifically, with recognized capital investments. And to be slightly technical, variations in the sources from which the funds are derived could be a powerful instrument of fiscal policy.

This powerful instrument of fiscal policy requires explicit coördination of the financial operations of federal authorities, and it would be well at the same time to bring about informed collaboration among the fiscal, monetary and lending agencies of the federal government.

Our people generally accept the proposition that it is in the national interest to balance the budget. There are two reasons that support convincingly a balanced budget policy. We want to balance the budget, first, in order to protect the value of the dollar; and second to make sure that we have a firm test of discipline that will keep us from spending beyond our means.

These are understandable and good reasons for wanting to achieve a balanced budget, and the fact that these are good

reasons and the fact that the public earnestly wants the security of a balanced budget make it imperative to have the word "budget" and the word "balance" make sense. Certainly no one wants to balance a traditional system of financial record keeping. Certainly no budget that is a hodgepodge of capital and current items can be balanced except by adding up columns of figures to see whether the totals are the same.

As is well known, the present so-called federal budget is nothing more than a system of financial record keeping. It is in fact a hodgepodge of current and accrual items, of exclusions and inclusions. All taken together, of whatever historical interest or administrative convenience, it is only a listing of numbers with no over-all financial meaning. It is misleading as a guide to appraising the impact of the federal government's intake and outgo on the private economy and on the soundness of money. It has no economic significance.

What are the obstacles to this budget reform program?

The first general criticism is that if the budget reform program is adopted, showing that tax requirements are presently overstated by $12 billion, the pressure for cutting expenditures will be eased, and Congress will become irresponsible in the making of appropriations. This criticism seems to me to be superficial. Even if the tax burden is reduced, taxes will still be dangerously heavy, and every sound measure of expenditure reduction will still be required to get the burden of taxes down. Futhermore, Congress will not be deceived forever by faulty accounting. Congress will want to know whether its appropriations for capital items can be covered by interest and amortization payments from receipts, public or private. Congress will not be misled by incorrect numbers on an accounting sheet. The deception is like that of a father who wants his son to drive the automobile only 45 miles an hour, and dopes up the speedometer so that it reads 65 miles when the car is only going 45. This father would spend his time better in persuading his son that speeding is dangerous. The boy will soon learn that the doped up speedometer can be safely ignored.

Another type of reservation comes from those who find the present accounting system convenient to their desires to impose new forms of taxation—especially a federal manufacturers excise tax or a general retail sales tax. For those who want new forms

of taxation, their arguments have as much or as little cogency in connection with budget reform as they have under our present system of financial record keeping. But I must confess that the urgency to act on their proposals will be far less.

There have also been attacks by name-calling, in which they refer to the proposed budget reform as a trick, a subterfuge, as legerdemain. As a matter of fact, vaccination is a trick against smallpox, an airplane is a subterfuge to avoid walking to California, and all good surgery is legerdemain, and very useful it is, too.

Finally, there is the understandable hesitation on the part of the government to solve our federal financial problem merely by changing the rules. It will require real courage in the Administration to recommend these long-overdue changes in the federal budget. Not only will the inertia of tradition have to be overcome, but there will be an inevitable amount of cynical comment that the Administration is attempting to balance the budget by definition. On the other hand, the first step toward a firm solution of our fiscal policy questions requires that these reforms in our budget be made.

Unfortunately, or perhaps fortunately, the Administration will be embarrassed either way. If it does not put through the budget reform program only because it will be embarrassed, it is sure to be embarrassed because it lacked the courage to do the right thing lest in doing so it would be embarrassed. Since embarrassment is probably unavoidable in either case, it might be better suffered in the cause of wisdom than in the cause of tradition.

We need a budget reform program. It is indispensable to a tax reform program. Otherwise a tax reform program will be constructed on shifting sands and will signify nothing. We need a budget reform program that will replace our present system of financial record keeping with a consolidated cash budget that will separate items that are clearly capital items from all the items that should be treated as expense and financed by taxation.

Then we shall know what the budget is and what balance means, and our aspiration for a balanced budget will be supported by clarity and purpose.

Remarks by the Chairman

Chairman Dean: Thank you, Mr. Ruml.

The question period will be postponed until after we have heard the remaining addresses.

I regret to report that an emergency has prevented Professor Seltzer from coming.

Our next speaker will be John Lintner, who is Associate Professor of Business Administration, Graduate School of Business Administration, Harvard University. He will speak on "Taxes: Their Effect on Investment".

Private capital expenditures are the key to the future growth, efficiency and stability of the American economy. They control the expansion of our productive capacity. Capital expenditures effectuate technical progress, thus helping to protect consumers and investors against the seemingly endless progression of wage increases. They are also the basic economic source of these wage hikes, since they embody the forward studies of advancing technology. Finally, the cyclical volatility and discretionary timing of capital outlays make their behavior pivotal for the stability of the economy.

Clearly then, in order to determine whether the federal tax system is a source of strength or weakness we need to learn how taxes affect personal and business investment. To tell us, we could not hope for a better authority than Professor John Lintner. Not only does he have a clear understanding of the intricate theoretical analyses of how taxes are expected to influence personal and business behavior; he goes out into the business world and finds what people actually do.

Mr. Lintner is a key member of the team of young men who have done distinguished work on the fascinating subject of what business men and investors actually do in response to tax stimuli. For the first time in our history we are beginning to build a firm structure of case-by-case knowledge of the effects of taxation. Professor Lintner!

CORPORATE INCOME TAXES: THEIR EFFECT ON INVESTMENT

JOHN LINTNER

Associate Professor of Business Administration,
Graduate School of Business Administration, Harvard University

ANY good title is supposed to be short. I suppose on that approach the title for all the talks this morning should be "Taxes!"—with the exclamation point.

Since Mr. Ruml has reformed both the budget and the tax system, and Mr. Grand is also going to revise if not reform the tax system, I think that it will be appropriate for me to focus my remarks a little more narrowly. I am consequently going to speak about the effects of taxes on investment, and most of my remarks will focus upon the effects of high corporate taxes on the volume of investment which corporations will be able and willing to undertake.

I feel encouraged in concentrating on the effect of corporate taxes on investment by the fact that the two other major taxes to be discussed would be sales taxes and personal income taxes. I will have some comments to make on the effect of sales taxes on investment in any event, and I would not have anything to add today to the results of the comprehensive study by my colleagues, Professors Butters, Thompson and Bollinger, on the *Effects of Taxation on Investment by Individuals*, which was recently published by our Division of Research. Since there have been some misunderstanding and misleading reports of their conclusions, and since these are directly relevant to our topic this morning, however, I will summarize briefly some of the more important results of their study.

Their factual investigation emphasized the importance of the stockholdings of the upper income groups. They found, for instance, that half of all privately owned stock is held by those who have incomes of over $25,000. And they found that the changes in the tax structure over the last fifteen to twenty years have substantially reduced the capacity of individuals in the upper income bracket—those who owned over half the stock—to accumulate new investible funds. They also found, however,

that the remaining capacity—in the sense of current accumulations of investible funds—of these upper income groups is still very large and actually larger than generally supposed.

After carefully analyzing the complex effects of taxes on investors with different investment objectives—such as security, or capital appreciation, or income—in each income bracket, they concluded that not only did the personal income tax structure reduce the investment capacity of these upper income groups which are the strategic source of future capital for investment in business, but it also reduced the willingness of the holders of capital on balance to make investments in equity securities.

The principal favorable feature of the tax structure—and this is an important one—is the stimulus it gives to higher-risk investments by venturesome-minded investors. There is a large differential between high marginal tax rates on ordinary income, including dividends, and relatively low capital gains rates, and this difference in rates provides a positive incentive for investors already venturesome-minded to increase the amount of their venture investments.

But their best over-all judgment was that, in spite of this positive stimulation, the high personal tax rates of recent years have been a deterrent to investment, and that the willingness of all the upper income groups together to invest what funds they still had after high tax rates in business investments, particularly in equities, was reduced. They also found that, while the net reduction was relatively small during the period when the studies were made—1949 and 1950—because of optimistic expectations, good business conditions, high levels of employment and income, these repressive effects would become very much more serious with less favorable conditions in prospect.

Such is all I need to say regarding the effects of the personal income tax on investment. It does deter business investment by reducing on balance the individual capital that would otherwise be made available to business. Among other things, the personal tax thereby reduces the prices at which businesses would be able to sell securities and there are other effects equally obvious and important.

For the rest of my remarks I should like to discuss the effects of high corporate taxes on the volume of investment which corporations will be able and willing to undertake. I shall focus

on the changes in the volume of investment which are due to the use of these taxes instead of others by the Treasury to secure a large part of the money it spends. To sharpen the issues, I will discuss the effect of relying heavily on these taxes to finance a fixed level of public expenditures.

Corporate income taxes can influence the volume of investment which corporations will undertake by affecting (1) the companies' *incentives* to make new investments and (2) the supply of funds available to finance them from both internal and external sources. The effects of the tax in each of these respects depend on who really bears the burden of the tax.

Business men have often opposed any heavy reliance on the corporate income tax on the grounds that "Corporate taxes are simply costs. The method of their assessment [i.e., whether levied on profits, sales, or physical property] does not change this fact. Costs must be paid by the public in prices and corporate taxes are then in effect concealed sales taxes."[1] Or again:

> Business organizations, by their very nature, are merely tax collectors, not taxpayers. The cardinal rule of every business—the purpose of any profit-making organization—is to earn a fair return on the money invested. To survive, it must pay its costs and have a fair profit left over. And taxes are just another item of cost. If income taxes take half of a corporation's profits, then it must set its prices high enough to earn twice as much before taxes in order to have the same return.[2]

Now if the entire burden of the corporate income tax is reflected in higher prices (or reduced wages), and rates of return on existing capital investments are fully maintained—as these statements hold to be the case—profits after taxes would not be affected and the amount of funds available from current operations to finance working capital requirements and new outlays on plant and equipment would be as large with high corporate taxes as with low. Moreover, in most respects the terms on which outside funds would be available should not be seriously affected. Net earnings per share on existing stock would be no

[1] Statement of Mr. Enders M. Vorhees while Chairman of the Finance Committee of the U. S. Steel Corporation, reported in the *New York Times*, October 10, 1943. Quoted in Richard Goode, "The Corporation Income Tax and the Price Level", *American Economic Review*, March 1945, p. 40.

[2] *Newsweek*, December 12, 1949.

lower, and there is no reason to expect dividends to be reduced since all the funds needed to pay the corporate income tax are supposed to have been supplied by customers. With earnings and dividends maintained, stock prices should not be seriously affected, and the cost of capital should not be increased.

Incidentally, we may also note that, with the corporate income tax fully shifted to others and net earnings and dividends maintained, the alleged double taxation of dividends would be no more than a horrible ghost to shock people. The tax under these conditions would doubtless be subject to serious charges of inequity and harmful economic effects on other grounds,[3] but it would not impose inequitable or undesirable burdens on individual investors.

Even if the corporate income tax were actually shifted so completely onto the consumer and worker, however, reliance on a corporate income tax to finance a given volume of government expenditure would probably reduce the amount of new investment actually undertaken rather significantly. The reason is that substantial increases in prices (or reductions in labor and other income) would be required to pass on the tax, and unit sales volume would be considerably reduced. (I am, of course, assuming that there are no independent favorable changes in monetary conditions.) With lower volume, less plant capacity and working capital would be required, and consequently the volume of new investment would be significantly lowered. Let me repeat that this reduction in the volume of investment would occur even though the tax were fully passed on in higher prices. This effect of the tax, to the extent that it is generally shifted, has an important bearing on any over-all appraisal of the desirability of using it to finance a substantial part of the federal budget. At the same time we must recognize that, to the extent the burden of the tax does not rest on the company and its stockholders, the usual complaints against the tax from the point of view of the company and the investor are without merit.

These considerations are worth emphasizing because there seems to be little doubt that there actually is a significant amount of shifting of the corporate income tax, even in the short run.

[3] In effect it would be a crude, highly uneven, discriminating and regressive sales and/or payroll tax, levied at all levels of the production line and capriciously pyramided.

At the same time I am not one of those who believe that the burden of the corporate income tax is so easily, or promptly, or completely, shifted to the helpless American consumer and laboring men as the quotations I have given would suggest. Much more solid research devoted to getting at the actual facts regarding the amount of shifting that really occurs under different conditions is badly needed, and I would not want to profess to have the answer for you this morning. My own limited studies of these matters, however, suggest that while the amount of short-run shifting which occurs is greater than economists have generally recognized, the larger part of the burden of the corporate income tax outside of regulated industries does rest upon the corporation and its stockholders. The rest of my discussion will be based on the presumption that this view of the incidence of the tax is substantially correct. In order to sharpen the issues I will simply assume in what follows that the entire burden of the tax is on the company and its shareholders.

What, then, are the effects on investment of the large part of the corporate tax which is not shifted? This part of the tax, because it is not reflected in prices and wage rates, will not reduce operating volume in the short run, and investments that are geared to building up and maintaining adequate capacity will not be cut back because of declines in unit sales. But the net profits which can be expected on new investments to expand capacity and the net gains to be realized from aggressive replacement of existing facilities will be reduced to the full extent of the tax liability. At the same time, rates of return on old investments, and consequently the supply of funds from current operations which are available to finance new investments, will be reduced by the full amount of the tax except to the extent that dividends are invested. Moreover, since these lowered earnings and dividends on outstanding investments will be reflected more or less fully in market prices, the tax will increase the cost of new equity capital and make this source of capital less acceptable. The tax will often also impair a company's access to debt capital or diminish the desirability of using these funds.

In short, the tax, when not shifted, will reduce the volume of investment that is undertaken by corporations because profit incentives are reduced at the same time that the internal supply

of funds and the availability and acceptability of outside capital are restricted. Both lines of effect are unquestionably important in restricting the total volume of investment.

We must be careful, however, not to double-count the restrictive effects of the tax, as has been done all too frequently. Suppose the tax, for instance, cuts into the supply of investment capital available on acceptable terms to a given company by \$5 million, and that at the same time \$3 million of otherwise attractive projects are no longer attractive because the corporate tax has reduced their prospective net returns below an acceptable level. The reduction in the firm's investments would then be \$5 million—the larger figure—and not \$8 million, the sum of the two. In judging the total restriction on investment attributable to the tax we must look to the larger of the two cutbacks. Ideally, this should be done on a company by company basis and the results totaled for the economy, allowing, of course, for the interacting effects of one company's investments on another company's volume throughout the system. Since the information that would be needed for such detailed estimates is not available, we must rely on more general observations and be content this morning with rather rough bench-mark estimates in what follows.

On the basis of my studies of these matters to date, I am inclined to believe that during generally prosperous periods, the volume of investment is reduced by the impact of corporate income tax on the financial capacity of companies more seriously than it is reduced by the effects of the tax on investment incentives. In other words, the volume of investment not undertaken because of the effects of the corporate tax on the availability of capital on acceptable terms is probably generally greater during such conditions than the volume of projects abandoned because of reduced incentives where adequate financing is available on acceptable terms in spite of the tax.

Since many popular and most theoretical discussions attach special importance to the incentive aspects, I want to make it perfectly clear that I am not saying that adequate profit incentives are not important to business. They unquestionably are important. Indeed a satisfactory level of profits as a reward for efficiency, enterprise, and risk-taking is essential if the system as we know it—and want it to be—is to function satisfactorily. Nor am I denying that the corporate income tax at

high rates sharply reduces the net financial gains that can be expected on new investments. I have just affirmed in unqualified language that they do.

But we must surely recognize that the modern corporation is not a simple one-celled organism motivated solely and exclusively by profits. Satisfactory profits are one of the basic objectives of its over-all operations, and, in many if not all cases where satisfactory profits are not being obtained, profit considerations may become controlling in managements' decisions. Nevertheless other considerations generally loom large in investment decisions, as they do in other aspects of company policy. So long as profit positions are not unacceptably low and the necessary funds are available, very substantial amounts of new investment will be undertaken even where there is no very clear evidence that the individual investment moves will add enough to net profit to make them worth while on that ground alone. As illustrations, we might mention investments which have been made in order to maintain or improve a company's competitive position, or to improve working conditions or employee relations, to increase the share of a market, or simply, as one executive put it, "to get to be the kind of a company we want to be." It isn't that profits will not in some way be increased, but the amount of the increase in profits is indefinite, or not too specific in many cases, and the effect of a tax, taking other factors into account, is not in many of these cases controlling. This sort of action seems to be particularly frequent where the funds being used are supplied internally; much more demanding financial conditions are often placed on investments that would have to be financed with outside money.

We must also recognize that, even so far as strict profit considerations are involved in investment decisions, companies look to the amount of potential loss involved as well as to the rate of return that will probably be realized if the outcome is successful. While the net gain with success is reduced by the tax, the amount of the loss if the project turns out badly is also reduced in the same proportion for all investment outlays where the commitment does not exceed the reasonably assured taxable income from all other operations.[4] Also, there are some special pro-

[4] The full period over which losses can be carried forward and backward should be included in judging the probable amount of taxable income against which losses can be offset.

visions in the tax structure intended to stimulate certain important forms of investment, such as special depletion provisions and accelerated amortization of defense-related facilities.

Still other factors suggest that changes in available funds brought about by taxes are likely to be generally more important in determining the total reduction in investment outlays than any effects on profit incentive per se, so long as business conditions are favorable, but I will mention only one more this morning. We know that there are many companies which have a firm over-all policy of limiting investment outlays (apart from some temporary short-term borrowing) to funds thrown off by current operations. These are well-managed and efficient companies whose product-development men, research staffs, and engineers are turning up a substantially larger volume of promising new investment opportunities than the available funds will finance (or the management organization and staff will support). The expected profitability of excluded projects is substantially greater than minimum acceptance levels because other things than profitability are the controlling or limiting factors in the situation. Here again, so long as business conditions and prospects are favorable, high income taxes or substantial increases in taxes may not reduce the actual total volume of investments made, as the usual theory ignoring this constraint would have suggested. The profit expectation is reduced but it is still larger than necessary for firms to go ahead with the volume of investment justified in the light of available funds and staff.

For all these reasons, then, I should not expect that, during prosperous periods such as we have enjoyed since the war, the volume of investment lost because of the effects of taxes on profit incentives—after allowing for the reductions due to restricted availability of capital—has been very great. And it is during such periods, of course, that the great bulk of all investing occurs.[5]

How large then have been the reductions in investment due to restrictions on funds available for financing? While a complete and accurate answer is obviously impossible, we can get a rough bench mark which may be useful. (The figures which

[5] As one rough indication, we may note that, after allowing for price changes, the last seven years account for about three fifths of all the producers' equipment installed during the entire 24 years since 1929.

follow refer to all corporations other than utilities, transportation and finance. These concerns are excluded because most of the tax on them was presumably shifted, or in the case of finance companies investment in plant and equipment and inventories was relatively small.)

During the seven years 1946 through 1952, income and profits taxes amounted to $89.7 billion. If these corporate taxes had been only half as large as they were—this would imply rates ranging from 19 per cent to 41 per cent instead of 38 per cent to 82 per cent—internal funds would have been larger by no more than $35–$37 billion after allowing for increased dividends *even if* unit volume had been maintained. But the government would have had to resort to some other source of revenue to make up lower corporate taxes—unless we wanted to run at a deficit during prosperous periods, which I think we would not want to do—and the amounts involved would have required roughly a 25 per cent increase in the personal income taxes already being collected or federal retail sales tax of 5–10 per cent (depending on exemptions). Quite apart from political feasibility or even social or general economic desirability, such taxes would have reduced unit volume considerably—and, as we all know, cuts in volume produce far more than proportionate drops in profits and still sharper declines in retained earnings. But the end is not yet, since the reduced volume in the earlier years would have had a cumulative depressing effect on incomes and sales.

All in all, without going into the details of the estimates, it would appear that shifting as much as half the corporate tax to either personal income taxes or consumption taxes would have increased internal funds available for investment by no more than possibly $25 billion for the entire seven years—or by about $3½ billion per year as an over-all average. This can be taken as a rough estimate, then, of the reduction in internal funds resulting from the policy of having corporate rates at the high levels they were instead of at the lower levels mentioned, provided that other taxes were used to make up the loss in federal revenues. Incidentally, you will notice that, while this shift in taxes would have left corporations with more funds from operations to spend on investment projects, the loss in volume would have reduced the need for new capacity and hence some incentives to invest.

Using this $25 billion figure for the seven years as a bench mark, we could say that the reduction in internal funds available for investment resulting from a doubling of corporate tax rates in lieu of using other revenue sources amounted to roughly one fifth of the funds actually retained in spite of the higher corporate tax actually in effect. But the reduction in the volume of investments actually undertaken was obviously very much less than this because the pinch on internal funds led many companies to go to insurance companies with private placements and to the open market with both stock and bond issues to fill out the financing needed for the investments they wanted and needed to make.

At least so far as debt is concerned, the post-war period is a beautiful illustration of the conditions under which this resort to other financing would be most likely to occur. The pressure for expansion has been intense, booming business has fortified profit anticipations, interest rates till 1951 were at historic lows, and high tax rates simply made the net costs of outside debt still lower. At the same time, thanks to war-time retentions of earnings, net worth was generally exceptionally strong in relation to debt and, thanks to continuing high profits and restrained dividend policies, equity positions continued to be favorable for several years.

Since Korea and the "accord" the underlying pattern is different but equally favorable to the use of outside debt to make up deficiencies in internally supplied funds. Increasing interest rates were in good part offset by increasing tax rates so far as net costs are concerned. The added lure of accelerated amortization was reintroduced along with technical features of the excess profits tax which made it profitable for a good many companies to borrow money even if they sat on it. Since investing it would generally be still better, the volume of investment in plant and equipment was also increased.

Clearly, we have had heavy reliance on outside funds, especially debt, to make up much at least of the reductions in internally available financing needed to support high levels of investment outlays—outlays that business was wanting to make. Debt issues and private placements in 1946–1952 amounted to more than $40 billion (again excluding regulated industries). These are estimates made by the Federal Reserve Board in

Washington. While some part of this debt would have been incurred anyway, there is no question that a large part of it was incurred to maintain desired and needed levels of investment in spite of high tax rates.

Some part of the difference was possibly also made up with issues of new equity securities. But as is well known, the effects of the tax on equity issues are quite different than on debt. Here, the higher tax rates reduced net earnings and dividends and thereby market prices on shares, so that the cost of equity capital was increased and new flotations were made less attractive than they would have been with lower corporate taxes. Nevertheless, with high levels of business activity and incomes, and with relatively favorable market levels for attractively situated concerns over much of the post-war period, many companies have been able and willing to float new equity securities. The total volume, however, has been only on the order of one tenth of new debt and private placements.

My conclusions therefore on the effects of corporate income tax on levels of investment are:

1. The tax does significantly repress the volume of investment which would otherwise be undertaken by corporations, both by reducing financial incentives and by restricting the availability of capital.

2. In times, however, of booming business conditions, continuing high incomes, and pressure of existing capacity as well as generally favorable equity and liquidity positions buttressed by an easy money policy, the actual reduction in total investment may be relatively small. (a) Under such conditions, investment incentives can be so strong that, even though heavily reduced by tax considerations, they still will call forth all the investment the companies can finance, and also all the investment the economy can handle without inflation or serious disruption of other demands. (b) Under these conditions, moreover, most companies can readily make up with outside capital such reductions in internal funds as may be due to higher taxes.

3. During the post-war period, the corporate tax served the useful purpose of reducing investment demands more nearly to levels which the economy could satisfy without undue strain and added inflationary pressures. It did not, however, greatly reduce the volume of real investment in the brick mortar and machinery in place and the physical goods on the shelves.

4. Under generally prosperous business conditions, but without the abnormal favorable features of the last few years, the tax would reduce the volume of investment much more seriously. Under these conditions, the effects of the tax on the supplies of capital available on acceptable terms to finance investment would probably reduce the volume of investments undertaken somewhat more than the effects of the tax on investment incentives, which would still be strong and probably rather inelastic.

5. With a downturn in business, the effects of the tax on investment incentives would be relatively more important and the balance between the effects on incentives and on supplies of funds might well be reversed.

6. Since alternative sources of tax revenue would also reduce investment incentives and the funds available to corporations, the *net* restriction of investment attributable to using corporate income taxes is less than would be indicated by considering only the direct effects of the tax that have been frequently overlooked.

7. The structural effects of the tax are likely to be fully as important under most conditions as the effects of high corporate taxes on the over-all total volume of investment. I am referring here particularly to the effects of the tax on the kinds of investments that are undertaken, and on the sizes and types of firms that can continue with their investment plans in spite of the tax. In this connection, the markedly more restrictive effects of the high corporate income taxes on the investments and growth of younger and less well established, though otherwise very promising, concerns are particularly serious, as I have shown in detail elsewhere.[6]

[1] See J. Keith Butters and John Lintner, *Effect of Federal Taxes on Growing Enterprises* (Boston, 1945).

Remarks

Chairman Dean: Thank you, Mr. Lintner.

Our next speaker is Mr. Gordon Grand, who will talk about "Proposals for Revising the Tax System".

Tax revision proposals have emerged from the dim cloisters into the brash klieg lights of the political hurley-burley. Time was when they were merely homeopathic intellectual exercises for graduate students. Now that it appears that a world-girding wave of tax revisions follows each world war, these gentle exercises take on sharp reality. And now that taxes hit us, every one, revision proposals start strident arguments in Pullman cars and stir the imagination of the proletariat.

We heard from our business man and from our academician and now we are to hear from our lawyer. It is important to know how the business man reacts; it is enlightening to know what the academician thinks; but the only one of the three who can do anything about the federal tax system is the lawyer.

Mr. Grand is a graduate of the Harvard Law School. After practicing law in New York City, he served as counsel to the Republican members of the Ways and Means Committee during the period 1948 to June of 1953. The key rôle of the Ways and Means Committee in tax reform has been indicated by Mr. Ruml.

Mr. Grand's present job is Assistant to the President of Olin Industries. Olin Industries is a remarkable firm which has defied precepts of growth and integration that have been laid down for centuries. There seems to be little similarity among the kinds of products or enterprises that this unusual firm is able to digest. It is in the sporting arms business, the paper business, cellophane, metals, chemicals, and recently has gone into the gas and oil business. As you can see, being Assistant to the President of such a remarkable conglomeration of enterprises puts Mr. Grand in an enviable position to observe firsthand the way in which the present tax system affects the conduct of a variety of enterprises, and to project the way proposed reforms would affect corporate conduct.

It gives me great pleasure to present to you Mr. Gordon Grand.

Mr. Gordon Grand: After that introduction, I feel as though I should take this opportunity to observe that "Every Day Almost Every American Uses an Olin Product!"

I wish Mr. Ruml had not made the observation that unless there is budgetary reform, tax reform will be as the shifting of sands signifying nothing. This observation presents a serious handicap for me to overcome. It would, I suggest, have been more appropriate for me to have been the first speaker. This is so because from the informal observations I plan to make you will realize the importance of budget reform and control. And if I may say so, in this and other fields Mr. Ruml has always commanded the highest attention from the members of the Ways and Means Committee.

PROPOSALS FOR REVISING THE TAX SYSTEM

GORDON GRAND
Assistant to the President, Olin Industries, Inc.

"INCREASE the personal exemption, eliminate double-taxation of dividends, remove the percentage limitation on medical expenses, permit taxpayers using the LIFO method to value their inventories at the lower of cost or market, authorize optional depreciation, provide relief for small corporations, broaden the definition of business expense to include child-care. These", said the noble Don Quixote as he prepared to assault the windmill, "are but a trifling few of the proposals I have in mind for revising the tax system."

"And these, friend Sancho, are in addition, of course, to a substantial across-the-board reduction in individual and corporate rates and the elimination of all the discriminatory features of the selective excises!"

But alas, Mr. Chairman, I am compelled to suggest that if this, or indeed any, discussion of proposals for revising the tax system is to be more than a pleasurable excursion of romance, we must at the outset recognize the existence of three harsh realities—high federal expenditures, a balanced-budget objective and the fact that, as a general rule, Congressmen prefer to be reëlected. Let us note these in that order.

It is perhaps trite to observe, but nevertheless well to remember, that the principal purpose of any tax system is a fiscal one—to raise the necessary revenue to meet the cost of government. There are subsidiary objectives, of course, and our tax laws contain many minor, and indeed even major, provisions of a regulatory nature. The tax on narcotic drugs, the excise tax on wagering imposed by the Revenue Act of 1951, our estate and gift taxes which are essentially social in nature, the excess profits tax, the tax on capital gains—all of these have a purpose in addition to that of raising revenue. But the paramount purpose is a fiscal one, and a reasonable estimate is that federal expenditures for fiscal 1954 will be in the neighborhood of $72 billion. The most sanguine expenditure estimate for fiscal 1955 that I have read to date is $66 billion, but this I fear will turn

out to be on the low side. Whether these expenditures can and should be reduced, and by what amount, is not within the scope of this discussion. Suffice it to say for our purposes that we are in a high expenditure period and that until there is a drastic change for the better in the international climate these expenditures must, of necessity, continue at a high level, although there is good reason to believe not on as high a level as at the present time.

The adoption of many tax revision proposals resulting in a loss of revenue might conceivably be justified in a period of high expenditures under an economic or flexible budgetary policy. Under this policy, standards for determining receipts and expenditures are based primarily on economic needs and any relationship between the two is coincidental. The combination of the high-expenditure factor and a balanced-budget goal automatically precludes consideration of these proposals except perhaps on the basis of a theoretical long-range target. I hope, however, to talk realities, not theory, despite the handicap of a balanced-budget goal to which I believe we all subscribe.

The extent of this handicap is seen from the fact that the estimated deficit for fiscal 1954 is about $4 billion. The scheduled reductions in existing law are estimated to cost an approximate $5.7 billion for fiscal 1955 and close to $7.5 billion on a full-year liability basis. This, assuming a continuation of present levels of business activity and personal income, would reduce net receipts to an approximate $62.5 billion—some $10 billion less than current expenditures.

And the third factor of limitation which must be considered in any realistic discussion of proposals for revising our tax system is the fact that the Congress is the core of the federal taxing process, and the people the final arbitrators. For this reason many tax proposals which might appear to be desirable can be quickly discarded as politically impractical. At this time we can dismiss consideration of, for example, proposals to tax the net margins of coöperatives, to reduce the percentage depletion on oil and gas, or to tax future issues of state and local bonds. And for this reason, too, I shall not discuss the arguments for and against the imposition at this time of a national sales tax. The political impossibility, short of all-out war, of openly enacting a general sales tax either at a manufacturers or retail level does not,

however, preclude as politically impractical the making of an important adjustment in our excise tax law. Semantics must not be underestimated as a factor in the making of tax policy.

Having by these observations protected, or at least intended to protect, myself from the sins of both omission and commission, I now feel sufficiently safe to move forward into the heart of the problem.

We can all agree, I think, that the objective of our tax system is a system which is best designed to promote the national interest. The issue is in the meaning of "national interest" and the methods to achieve it. I suggest to you that, as a yardstick against which to measure tax revision proposals, the national interest today means a tax system designed to produce the maximum revenue for an indefinite time with the minimum jeopardy to our free society and the minimum interference with our productive forces.

This over-all goal can be distinguished from the tax policy of an all-out shooting war in which the curbing of inflation and the curtailing of civilian production must be of prime consideration and taxes are imposed to achieve this result. It can be distinguished also from the economic and fiscal objectives in a period of abrupt change from total war to peace as in 1945, and from the period of 1947–1948 when we were faced with the novelty of a budget surplus.

The important characteristic, and the one which distinguishes this tax policy objective from broad policies in the past, is that our tax system must be geared for an indefinite period of high expenditures required for national defense. Under this tax objective, emphasis must be placed on preserving our taxable capacity on a sustained high-yield basis and at the same time stimulating expansion of productive revenue sources for the future.

To the end that our present tax structure may more adequately meet this need, I propose, as a first step, that the present imbalance between the proportionate yield from our income and excises be adjusted. This imbalance exists in the fact that we are currently collecting only 14½ per cent of total revenue from excise taxes—only 4½ per cent more than during the height of World War II when production of civilian items was at a virtual standstill. In fiscal 1953 the yield was 15.3 per cent. The fact is that, as the result of the tax policies adopted by the Congress

since Korea, the yield from excises in relation to income taxes is at the lowest point in our history except for the 1944–45 period of drastically curtailed civilian production.

The most serious and immediate consequence of this imbalance, and one which will plague us, is the resulting lack of stability in our tax system. In our quest for revenue through high individual and corporate income tax rates, we have sacrificed the desirable element of stability. It has been estimated, for example, that a decline in business activity similar in proportion to the decline in 1949 over 1948 would result in a loss of revenue of $14 billion and a 1938-type decline in a loss of revenue of $26 billion.[1] In general, a 1949-type decline is based on a drop of 8.5 per cent in industry production, 5 per cent in wholesale commodity prices, and 1.7 per cent in the personal income level.

A decline in business activity to this extent is not, in my judgment, too remote a possibility. As defense expenditures recede from their present current rate of $43 billion a year, we can expect a downturn. It seems to me that the question is not whether a decline will occur, but rather what will be its pace and extent.

More specifically, on this point I recommend that the proportionate yield from excises be increased to approximately 20 per cent. The scheduled rate reductions provided in existing law together with the strong pressure on the Congress to enact needed adjustments in existing excise rates make this proposal politically feasible. The scheduled reductions to which I refer are: the termination of the excess profits tax on December 31, 1953; the approximate 10 per cent reduction in individual rates commencing January 1, 1954; the reduction from 30 per cent to 25 per cent in the corporate normal rate on April 1, 1954; and the reduction of certain excise rates also effective on April 1.

Of the estimated $7.5 billion loss on a full-year liability basis, from these reductions, $1 billion is attributable to excises, and thus the scheduled reductions themselves will tend to correct the imbalance. But, assuming an approximate $65 billion level of expenditures over the next two years, and this I think a reasonable assumption, an additional $2 billion above the current yield must be raised from excises if this approximate 20 per cent ratio is to be met.

[1] William R. Biggs, *The Federal Budget and Corporated Profits in a Business Decline.*

Are there sources available which, without doing violence to our standard of fairness or any other cardinal principal of taxation, will yield this amount? I believe there are and I have in mind, for example, such items as clothing, household furnishings and appliances, soft drinks, chewing gum and candy. A total tax equivalent of 5 per cent of the retail price on these commodities would yield, roughly, $1.7 billion. In addition to these commodities there are a number of services not now taxed which could appropriately be taxed. For example, the cleaning and repairing of taxable articles—those articles now taxed and those which might feasibly be made subject to new taxes—might be made subject to tax. The expenditures for such services amount to approximately $6 billion, and a 5 per cent tax on these services would, therefore, yield in the neighborhood of $300 million.

I cite these figures not in the nature of a prepared plan but to illustrate that there is room for substantial additional yield from excise sources. And in so doing I invite your attention to the fact that the commodities which I have suggested as possible candidates for new excises are taxed in Canada and Great Britain. At this point, too, let me make clear that any legislation extending the excise tax base should also make significant adjustments in the exceptionally high rates which now exist on certain commodities. The House version of the Revenue Act of 1950 was an effort to make these adjustments but was necessarily sidetracked as the result of Korea.

A tax program which shifts a heavier proportionate burden on excises will meet with little favor from the purchasing-power theory economists, from those who regard excises as both repressive and regressive, and from spokesmen in the industries affected. This is so, not only because of conflicting interests, but because admittedly there is no fixed formula for determining the ideal yield from each revenue source. In the final analysis, it is a question of personal judgment arrived at after consideration of a number of criteria. In the light of our tax policy goal, I have ascribed particular weight to the following factors. The first is the imperious need to acquire stability of receipts. The second is the general principle that the greater the diversity of revenue sources the larger is our taxable capacity. Under the tax objective I have outlined, full utilization of every revenue source is essential. The third is that in dealing with the over-all

problems of rates and burdens the merits of any particular type of tax must be judged in the setting as a component part of the whole tax structure. In considering, for example, the question of the fairness of shifting a portion of the burden to excises, we must not overlook the extent to which we have extended the principle of ability to pay through the use of high progressive surtax rates on individual income. It is this last point which leads me now to my second proposal which is that the individual income tax reductions scheduled for January 1 be revised with the view to making more realistic reductions in the progressive surtax rates on individual income.

Our income tax rates now run from 22.2 per cent to a maximum marginal rate of 92 per cent. For individuals in the middle and upper income tax brackets the scheduled reductions will afford little over-all relief. For example, the top marginal rate will be reduced from 92 per cent to 91 per cent; the 88 per cent marginal rate to 87 per cent; the 77 per cent marginal rate to 75 per cent. (Even from the lowest end the 22.2 per cent rate will drop to 20 per cent.) That these high rates have had and will continue to have an adverse effect on incentive and the willingness by taxpayers in the middle and upper brackets to invest in productive enterprises is, I believe, beyond dispute. The issue is not one of fact but of judgment as to whether the revenue derived from these rates outweighs the effect these rates have on incentive and on the source of equity funds from private investors. Involved, too, is the question of social philosophy. In my judgment progressive rates become primarily social in purpose at the point when the psychological effect is to lessen effort and put a premium on inaction. In general, I think that the break-even point for most people is an approximate 60 per cent rate and I recommend that existing progressive rates be redetermined with the view to fixing this rate as the maximum marginal point. At present income levels a maximum marginal rate of 60 per cent would involve a loss of revenue of some $800 million, but I am of the school which believes that this revenue would be quickly offset as the result of increased personal incentive.

There is, of course, considerable precedent for the theory that a reduction from high rate levels may in fact lead to increased yields. This was the experience under at least two of the tax

reduction acts in the 20's and again in 1948 and 1949 when income taxes were reduced and receipts fell substantially less than was originally estimated. There has, however, been considerable merit to the argument that since our economy is already operating at such an accelerated pace the analogy of the 20's or of 1948 did not apply. But it seems to me that this rebuttal loses much of its strength in the light of the leveling-off period with which we are now faced. If private capital is to take up the slack, additional incentive for taxpayers to invest in risk securities instead of tax-sheltered investments must be provided. Under present rates, taxpayers in the $22,000–$26,000 taxable bracket must obtain an equity yield of 6.6 per cent in order to equal a 2¼ per cent tax-exempt security. At the marginal rate of 77 per cent the necessary yield is 9.8 per cent, and at the 88 per cent marginal rate the required yield is 18.7 per cent.

Always to be considered is the fact that 800,000 new workers are added annually to our labor force. In 1945 the capital invested for each production worker in manufacturing was about $5,700. In 1951 this figure increased to approximately $11,000, and in the oil, chemical and public utility industries the cost of new plants and equipment has averaged over $30,000 per worker. It is estimated that the original investment in the new steel plant at Morrisville, Pennsylvania, will be in the neighborhood of $90,000 per worker. Direct investment by individuals must be encouraged if the necessary capital is to be supplied.

There are two other aspects which must not be overlooked in judging whether the continuation of the present high progressive rates will best promote the national interest as defined by our tax policy goal. The first is that the psychological limitation of taxation is a variable factor. It is obviously higher in times of grave national peril than at other times. If the limit is misjudged, taxpayer irritation may turn to something more and the under-the-counter transaction will become an accepted technique. Ours is a self-assessment system and depends for its effectiveness on the willingness of the people to determine fairly their own tax liability. Secondly, high rates lead inevitably to strong pressures for additional exemptions, deductions and relief provisions. A review of the recent hearings before the Committee on Ways and Means on tax revision proposals will show that the grievance of each spokesman stemmed essentially from the ex-

istence of high rates. The proposal for averaging of income, preferential treatment of earned income, retirement plans for the self-employed, are typical examples. Unless there is a substantial rate reduction, we can expect that the Congress will yield to these pressures, as it has yielded in the past. If all requested relief were granted, the tax base would be whittled to a fruitless size. Far better, it seems to me, than to attempt to correct all inequities on a case-by-case basis is to hold the line and strive for a continuous program of a general rate reduction. In the long run the loss of revenue will, I suggest, turn out to be less, and our taxable capacity strengthened.

The need, under the objectives of our tax policy goal, of a sustained dynamic economy faced with the problem of absorbing the withdrawal of the government as the dominant partner leads me also to my third proposal which is, in brief, that a beginning, at least, be made now to eliminate double taxation of corporate dividends.

Since 1936, corporate dividends have been taxable in full to noncorporate shareholders and no deduction for dividends paid is allowed the corporation. Corporate shareholders are given an 85 per cent credit for dividends received from another domestic corporation or from certain foreign corporations doing business in the United States. The failure of present law to give recognition to the corporate income tax to which corporate earnings are subject before they are available as distribution to stockholders is the basis of the double-taxation problem. Where the earnings received by a stockholder are those of a subsidiary corporation, there is, in effect, triple taxation to the extent of the tax paid by the parent corporation on 15 per cent of the dividends it receives from the subsidiary. It should be remembered, too, that interest paid on debt capital may be deducted from gross income, whereas dividends paid on equity capital are not deductible by the corporation. Tax advantage is thus given to the use of debt rather than equity financing.

The solution to the problem is not easy and there are many proposals from which to choose. Suggestions range from abolishing the corporate income tax altogether to changing the law to provide that interest on debt not be allowed as a deduction in determining taxable income. The proposal has also been made that all stockholders be placed on a salary by their respec-

tive corporations. The corporations would then deduct the salary payments in amounts which would be equal to the dividends due, as a business expense. It will not, I suggest, test the extremities of Congressional imagination to find objections to this proposal. My choice is the proposal to provide a limited credit at the stockholder level for dividends received. A taxpayer, with say $400 of dividends, would under this system compute his tax liability as under existing law and then deduct a percentage of this amount from his tax. It is estimated that a 10 per cent credit would result in an immediate loss of revenue of approximately $700 million. This loss would, I predict, as in the case of the immediate loss from a reduction in the progressive rates, be more than offset in a short time as the result of increased investment and the wider distribution of stock ownership by the public. This in itself is a desirable objective.

The British system of taxing dividends is in essence a withholding system. Under this approach, the corporation is viewed as having paid the corporate income tax for the benefit of the stockholder and the stockholder is required to include in his gross income the cash dividend he receives, plus the corporate income tax applicable thereto. The taxpayer is then permitted a credit against his own income tax equal to the amount of tax paid by the corporation.

Canada initiated a tax credit for dividends in 1949 and increased the amount of the credit from 10 per cent to 20 per cent in 1953.

It may be of interest to note the motive which underlay the recommendation to provide the dividends-received credit in Canada. Accordingly, let me quote a passage from the budget speech for 1948 of the Minister of Finance for Canada. He said:

> It seems to me that under a system of private enterprise which depends for its existence on a steady flow of venture capital we cannot afford to neglect the implication of this defect [the double taxation of dividends] in our system, which has been accentuated by the increase in both corporate and personal income tax rates . . . It is not a question of the immediate profit position of Canadian business because I think it is clear that today we in Canada are prosperous as never before. Rather it is a matter of concern for the future under a system where we depend, and must depend, for full employment and the creation of new wealth on the willingness of our people to risk their money in constructive enterprises.

Here in this country, in 1952, nonfinancial corporations obtained approximately 60 per cent of their capital from retained earnings, only 9 per cent from new equity financing, and 30 per cent from debt. Assuming an annual increase of 3 per cent per year in gross national product and capital formation of 15 per cent of gross national product, it is estimated that in 1960 some $67 billion in gross private capital formation will be required.

Related to the problem of double taxation of dividends is the question of the proper treatment of capital gains and losses. As a general rule investors consider not only the tax treatment of dividends, but also the tax consequences resulting from appreciation or decline in value. A tax system designed to encourage private investment must therefore consider both problems. Proposals in this field range from elimination of the tax altogether to the extension of the holding period and an increase in the rate. Present law is essentially a compromise between the two positions, but it appears to satisfy no one. Viewing it only as a question of revenue, I believe that a reduction in the holding period to 3 months would be warranted. In 1942 a maximum effective rate of 25 per cent was established and the minimum holding period was reduced from 18 to 6 months. Capital gain tax receipts in 1941 amounted to a net revenue loss of $250 million. Two years later capital gain tax receipts amounted to a plus of $335 million. This fact, together with the increased revenue yields from capital gain tax, is relied on in support of the theory of increased yield from a shorter holding period and I dare say this is true. The difficulty I have with a 3-month holding period proposal is that it makes the investor indistinguishable from the speculator and thus runs counter to the underlying concept. I prefer to approach the problem of unfreezing the great reservoir of capital funds by first reducing the effective rate, and I recommend that this be done. This could be accomplished by either a straight rate reduction or by reducing the amount of the gain subject to tax. I recommend the second approach by setting the percentage inclusion at 25 per cent instead of 50 per cent. As a further stimulus to investment, I favor the proposal to liberalize the treatment of capital losses. Under existing law, individual taxpayers may use a net capital loss as a deduction against ordinary income up to $1,000 in the year of the loss and any unused portion

may be carried over and used as a similar offset in the five succeeding years. The $1,000 a year limitation was fixed in 1942 and, in my judgment, is unrealistic in view of the price-level changes which have occurred since that time.

The third and final area of taxation I propose to discuss is the corporate tax and problems relating to the corporate tax base.

First, a word of history—the corporate tax and personal income tax were originally conceived of as companion taxes. For the period 1913 through 1916 the corporate rate and the normal rate for individuals were the same. In 1917 the corporate rate rose above the normal rate for individuals, but the two rates were brought into uniformity again in 1918. For the 16-year period from 1919 to 1935, the corporate rate was higher than the personal normal rate, but dividends were exempt from the normal tax, the theory being that the corporate tax was essentially a means of collecting personal income tax at the source. But in 1936, there came a major change in the philosophy of the business tax, and the exemption of dividends from the normal tax was eliminated. Today, we, in this country, have the highest corporate rate of any country in the world. The examination of other systems shows that in Brazil the corporate rate is 15 per cent; in Australia, 35 per cent; and in France, 34 per cent. Canada's top corporate rate is 47 per cent on that part of the income in excess of $20,000. The first $20,000 is taxed at a rate of only 18 per cent, while our starting rate is 30 per cent. As noted also, Canada now provides a 20 per cent dividends-received credit.

The need for revenue is the only logical justification for the corporate tax. Whether and to what extent the corporate tax is passed to the consumer is a controversial issue and need not concern us here except to note that if, of course, the full amount of the tax were shifted to the consumer, then there is no problem of double taxation of dividends.

It is clear that the corporate tax influences economic expansion and the higher the tax the greater the influence. Even when reserves to cover taxes are fully maintained, tax payments affect the supply of investment funds available for expansion. The corporate tax impedes expansion also because it lessens the chance that the pay-out of new undertakings may be accomplished within a reasonable time, and thus is a major factor.

Despite these uncomplimentary observations, I think it may well be necessary to continue the present high rate through 1954. This is due to the high expenditure factor. The choice may well resolve itself into whether it is preferable to reduce the corporate rate or to make remedial adjustments affecting the corporate tax base. If the choice must be made, my preference is to defer rate reduction temporarily and correct two other problems. The first of these is the question of depreciation—undoubtedly one of the most controversial and important problems in the tax field.

In a nutshell the law provides for a reasonable allowance for exhaustion and wear and tear (including allowance for obsolescence) of property used in the trade or business or held for the production of income. Depreciation must be deducted in accordance with a reasonably consistent plan that permits, in general, the aggregate deductions to equal the cost of the property (less salvage value) by the end of its useful life. The so-called straight-line method or any other method in accordance with established trade practice is acceptable. Since 1934, the regulations have provided that "the burden of proof will rest upon the taxpayer to sustain the deduction claimed." Bulletin "F" of the Bureau of Internal Revenue is used as a guide in determining useful life of property. It sets out estimated useful lives for various types of assets.

The controversy over depreciation is essentially twofold: (1) that the Bureau of Internal Revenue substitutes its own judgment for that of the taxpayer, and (2) that the present depreciation policy is too rigid and is unrealistic.

At best, any attempt to forecast not only the rate of deterioration, but also the obsolescence factor, is a difficult undertaking. As the result of the increase in the price level, depreciation allowances which are based on cost have become entirely unrealistic, and this inadequacy of original cost depreciation from a purchasing power standpoint has added impetus to the movement for reform.

There are a number of possible solutions. One would be to permit wider use of the declining balance system under which the fixed percentage write-off is applied to the depreciated basis of the property rather than to the original cost. Another possibility is to provide in the law a percentage range which the tax-

payer could use at his discretion. A third practical solution is to permit the taxpayer to depreciate a higher percentage of cost in the initial years.

The purpose of depreciation is, in general, to provide industry with a steady flow of untaxed funds sufficient, when reinvested in new capital assets, to offset the current consumption of their productive properties. It should be more than just a tax-free recovery of capital. Inadequate depreciation charges result in overstated profits and understated costs and a resulting loss in the capital funds needed by industry for replacement of obsolete equipment.

The second problem, and this involves insignificant revenue, is Section 102 of the Tax Code. In addition to the regular corporate rates, our tax laws in Section 102 of the Code impose a penalty surtax on a corporation which is "availed of for the purpose of preventing the imposition of the surtax on its shareholders . . . through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." This penalty surtax is in addition to regular corporate income taxes, and is at the rate of 27½ per cent on the undistributed earnings up to $100,000 in a year, and 38½ per cent on undistributed earnings in excess of $100,000. Provisions similar to the present Section 102 have been part of the tax laws for many years. The purpose is to prevent tax avoidance through the use of the corporate form of organization.

The principal inherent in Section 102 is a sound one, but there are valid criticisms, particularly by small business, to its practical application of the law. Small businesses allege that, because of the fear of the high penalty, they are prevented from retaining sufficient earnings to create a reserve against possible future loss periods. In view of their relatively poor credit position, they argue, and, I believe, rightly so, that they must accumulate sizable earnings in order to finance expansion. Depreciation allowances, which, as we have noted, are frequently inadequate in view of higher replacement costs, are also included among the reasons for the necessary retention of a relatively high proportion of earnings. It is claimed, moreover, that Section 102 favors large publicly held corporations which are less dependent on retained earnings and as a result this Section has been a factor in the absorption of small businesses.

The impact of Section 102 is primarily psychological, but there is no doubt that it fills with fear the heart of small businesses and closely held businesses. The reasons are twofold: First, Section 102 contains no fixed yardstick for the guidance of management, and secondly, once it is claimed that the corporation has accumulated earnings beyond its reasonable needs, the burden is on the taxpayer to prove by the clear preponderance of evidence that the accumulation is not for the purpose of avoiding income taxes.

I propose three changes—

(1) That the burden of proof be shifted to the Commissioner as is the case of other penalty provisions.

(2) That dividends declared and paid within 75 days after the close of the year be taken into account in determining the extent of retained earnings during the prior year. And,

(3) That the penalty tax be imposed only on that portion of the corporation's accumulation of surplus that is determined to be beyond the reasonable needs of the business. Under present law the base for the tax is not restricted to that portion of retained earnings deemed to be in excess of reasonable needs.

The proposals for revising the tax system which I have outlined to you are, it seems to me, within the budgetary and political limitations with which we are confronted at this time. There are, of course, a host of other changes which I feel should be made when conditions permit. I have in mind, for example, a more liberal tax treatment of foreign income, a long overdue correction in the taxation of annuities, and an equalization between corporate employees and the self-employed in the field of pensions. I am hopeful that the Congress will see its way clear to act on these and other desirable technical changes as quickly as possible.

I have, I fear, overtaxed your patience—no less a crime than overtaxing your pocketbooks. But assuredly in the tax policies we adopt lies the blueprint of the future strength of our country. The matter deserves our most careful study.

DISCUSSION: THE FEDERAL TAX SYSTEM: SOURCE OF STRENGTH OR WEAKNESS?

CHAIRMAN DEAN: We are much indebted to you, Mr. Grand.

Perhaps nine tenths of the questions which we had in our minds when we came here this morning have been answered. To the remaining one tenth we now have an opportunity to get answers directly from these distinguished speakers. Perhaps I should give the speakers themselves priority to question one another.

MR. LINTNER: I was interested in whether Mr. Grand was proposing a replacement in depreciation for the price level. You were skirting the point and I wasn't sure whether you were taking that position or not.

MR. GRAND: I skirted the point deliberately because although it may have merit in principle it presents serious administrative problems. Do you agree with me on this?

MR. LINTNER: Yes. In addition to the administrative problem there is also the question of equity as against holders of primarily financial assets. If you move to taxing a real internal base on holders of physical assets and give no credit for the loss in real value of financial assets during an inflationary period, an inequity is introduced into the tax system in order to eliminate an existing tax on admittedly capital values.

MR. GRAND: I agree with that.

MR. LINTNER: So that the original cost depreciation most of the time is, in effect, a tax on the capital gain that represents the increasing money or capital value of the physical assets.

MR. GRAND: I think that the major objection to present depreciation policies would be met by permitting a more flexible exercise of management's judgment and by recognizing that management's judgment should not be arbitrarily overruled by the Bureau.

QUESTION: Mr. Ruml, were you arguing for the changing of the trust fund to the social security payments on a cash basis? Your argument was that it would present a better picture. How about the announced capital list? Wouldn't that have the converse effect? I mean that the public authority which has spent funds would not be revealed in the budget. However, it would have the same impact on the economy.

MR. RUML: As a matter of fact, it wouldn't be revealed in a budget and probably not in *the* budget. But the difficulty that we have with these capital items is the fact that since they are now treated as expense, they are not subject to the type of deflation control that would come through the operation of debt management, and you can get some very good examples of that. I will give you the best I know that I got from Mr. Lilienthal recently.

There are two large power plants on the Ohio River. One is in private hands. The other is in the hands of the TVA. They were built recently. The purpose is to provide electricity to the atomic energy plants in that area.

The private plant was built and financed with funds that came from insurance companies and the collateral was the contract with the Atomic Energy Commission. The TVA plant was built by funds which were derived from taxation or, if not from taxation, from a showing in the *deficit.*

Now, it is perfectly clear that the funds coming from the insurance companies were withdrawals from savings that otherwise might have been invested some place else. Had the TVA power plant also been financed by capital rather than by taxation, the fiscal and monetary authorities could have chosen whether they would have financed by long-term debt or by the commercial banks, thereby giving a flexible element in fiscal policy that does not exist in taxation.

We are now seeing this thing happen right before our eyes. Not for the good reason that commodity credit should be financed outside the budget, but for the bad reason that there is a ceiling on the debt and, therefore, in order to avoid the debt ceiling, the Commodity Credit Corporation is now paying about one per cent more for the short term than the Treasury. As a measure of economy it seems to be a little absurd.

QUESTION: Mr. Ruml, I am quite sympathetic to the principles of segregating capital expenditures from revenue expenditures, but I think in terms of political tools and I grow a little fearful as to what might be defined as a capital expenditure and what control you would have over that definition. And did I understand correctly that you included our expenditure for atomic energy plants as a capital expenditure?

MR. RUML: I would include the expenditure for atomic energy plants to the extent that they are engaged in the production of plutonium which would be for sale by contract to the Defense Department.

It seems to me it makes no more sense to build a capital construction for plutonium from tax funds than it would be to build a steel mill from tax funds when the steel is to be sold by contract to the defense establishment.

I think you are quite correct and the definition is very important because there are many people who would like to call the Washington Monument a capital investment or any other memorial building, or any other structure that happens to be made out of brick and mortar. Therefore, these definitions and concepts are very important, but I think very clear, and let me repeat what I said: I am not in favor of what is generally called the capital budget. I think that it is much too loose. But I am in favor of distinguishing from expense those items which are purchased for resale, deducting the charges for carrying and depreciation. These

are your stockpiling of scarce materials and this commodity credit operation. I could discuss that at greater length but I won't. The second class is clearly revenue-producing items. When the government buys a mortgage it will pay 4½ per cent and the principal should be charged to taxation. I just don't see it and that is, of course, the most extreme case but there are many, many others.

Then there is the class of items which can be put into the class of authorities, and here I think the $4 billion figure which I mentioned is conservative. A good example of an existing one which was paid out of taxation is the Export-Import Bank, to which $1 billion was furnished from taxes. The Export-Import Bank has a surplus now of about $220 billion as well as earnings in interest charges. There was no excuse whatever for that to have been a charge against the taxpayer.

But again let me repeat that I agree with you completely that without some definitions and concepts either it is going into an inventory that is intended to be sold, or it is going into a productive item for which there is a charge for interest and depreciation. I think it should be excluded.

I want to follow this with just one more thought. The statement is sometimes made that under such a scheme Congress would lose control, if you please, of the demands for expenditure. I think, and some others feel, that, on the contrary, the controls would be better. If, for example, a county comes to Congress and wants $100,000 for a bridge across a little river. The question can be asked: is this bridge worth $6,000 to the taxpayers of this county? That is all it will take for 30 years to pay the interest and amortization. If the answer is, why shouldn't they have the $100,000? given the fact that labor and materials are available at their own expense and not charged to the taxpayers of the nation as a whole, and if it isn't worth $6,000 to them, then clearly you have the chance to raise the question: is there a national interest in the bridge across this river? There might be. It might be leading to the uranium field and that would be very good, but if it is only a bridge put across the river because the congressman wants to be reëlected, I think that $6,000 a year is not too much for his constituents to pay.

QUESTION: Mr. Lintner, if I have interpreted you correctly, you would say that the corporate tax would cut into investment more than income taxes or a sales tax, or a combination of the two. Now, if you take a sales tax, it is a consumers' tax and, assuming it would shift somewhat to the consumer savings, it would be a broader base than would an income tax or the corporate tax, and what savings it would cut into would be thus the savings that would go into risk investment, wouldn't they?

MR. LINTNER: On the first part of your question, my answer is generally yes, but I think you can't make any single sweeping statement. Also I think the savings cut off by a sales tax would be less likely to wind up in risky investments than you suggest.

I was pointing out that a corporate income tax would reduce both the incentives and the supply of funds for investment. It affects these even in times of very good business. But when incentives are strong, profit opportunities are great, and, as recently, money is otherwise readily available for a variety of reasons, the actual reduction in investment due to the corporate tax will be small. A general sales tax would probably have reduced investment more than the corporate income tax did during the period since the war. I did not generalize either way because, under other business conditions, the balance would probably be different. For instance it may very well be that within the next few years the effect of the corporate income tax on incentives would be much more serious. Also, incentives, say, for general investment introducing new products might not be subject to the broadly selective type of excise which Mr. Grand had in mind. The corporate income tax would have considerably more effect in this case.

It is hard to generalize because you have to think of different types of investments made by different types of companies and by those having or not having access to capital. You also have to think of different kinds of business conditions and different types of sales taxes. I certainly would not attempt to generalize in the way you suggest.

Question: Mr. Lintner, why do you believe, if I understood you correctly, that all the regulated industries are able to pass their taxes on to the consumer? I think the contrary is very true.

Mr. Lintner: I did not mean to say, and I regret if I gave the impression, that all of the tax on all regulated industry was completely and promptly passed on to the consumer. I am sure that it is not.

On the other hand, there are provisions for taxes in the rate base and considerably more of the tax will be passed on, certainly, in the regulated industries as a group, than in industry in general. For the purposes of getting an estimate, I chose to leave out the regulated industries and concentrate on manufacturing, trade and other concerns where it would seem that the tax was likely to be shifted. Certainly, in my judgment, a much smaller part of it will be shifted most of the time in these other industries.

Question: Well, I think that is debatable because in one case you are controlled by competition and in another case you are controlled by your regulated rates and the maximum that you could charge. But, on the other hand, very few utilities that I know of are able to earn the percentage that they are permitted to earn because of the fact that the maximum rate is not large enough to permit them to do so. So in one case it is competition that controls and in the other case it is regulation. I think if you check the whole field of regulated industries you will find that it is not passed on any more there than any other place.

MR. LINTNER: I am aware of the fact that a great many utilities are not earning up to the permitted rates, and I am also aware not only of the difficulty in determining what the rate base should be, but also of the complexities and delays in getting the determination and final decisions made. Even when granted, increases are not granted promptly in most cases.

I did not mean to imply—to repeat—that utilities do pass all of the tax burden on promptly and completely. In an introductory section I indicated that there would be a restriction on investment even where the tax would be completely shifted. I was more interested in discussing what I think is the more general case, at least outside the utility industry, where the tax is not shifted onto the consumer and worker. It is obviously a difficult matter of judgment as to just how much is shifted whether you are talking about utilities or others.

CHAIRMAN DEAN: I am sure we are grateful to our three distinguished speakers for their memorable performances and I want to bring to a close this morning's session of our 73rd Annual Meeting of the Academy of Political Science.

PART II

FIRMING UP THE ECONOMIC ARCH

SHEPARD MORGAN, *Presiding*
Member, Board of Directors, Academy of Political Science

IN opening this session of the Academy meeting I want to take you briefly into the confidence of the Board of Directors in the selection of the topic.

The general topic for this Annual Meeting of the Academy, as you see on the front page, is "The American Economy, Keystone of World Prosperity". The reason for that topic was this: It was first proposed that we discuss once more in the Academy a question of foreign policy or of economic policy or of political policy. It was said that we have been doing that for the last two or three meetings and it was time for a change. Accordingly the proposal was that the meeting have to do solely with American topics, but when it came to be worked out it was seen that a series of solely American topics necessarily impinged not simply on the United States, but upon the world because whatever happens here owing to the changes that have taken place in the last decade—the United States economy has become the dominant economy of the world—affects every country plus or minus, whatever that country may be or wherever it is situated. So it becomes especially incumbent upon us to do what we best can with forethought and energy to preserve the economy of the United States as a prosperous going concern. Therefore, the line-up of topics was, as you have seen, the extremely interesting series of talks that we had this morning on the various aspects of the issue of taxes, and this afternoon on questions that have to do with strengthening our existing situations.

Our first speaker is Mr. Albert G. Hart, Professor of Economics at Columbia University. Professor Hart is singularly well qualified to speak to us. He has had a broad experience with an undergraduate study in the United States and a postgraduate study in the United States, numerous travels abroad, later as a writer, as an economic expert in the service of the Treasury in Washington, and now at Columbia where he is a professor. Professor Hart!

ECONOMIC STABILIZATION AND THE BUSINESS OUTLOOK

ALBERT G. HART
Professor of Economics, Columbia University

THE United States has been enjoying a post-war prosperity that has now continued eight years. Our only noticeable business setback, in 1949, was both brief and shallow. Most of the time, unemployment has been below the lower limit of the range our optimistic post-war planners of 1944 and 1945 forecast would represent normal labor turnover in full prosperity. Both in intensity and in length, this post-war prosperity has outrun our previous record prosperity—that of 1923–1929. Now we are asking ourselves—can this last much longer, and if not, what then?

The Outlook

Our reasons for concern, of course, go deeper than a mere counting of years elapsed between the major depressions in the business annals. We all know that our post-war prosperity has been a period of catching up on needs of long standing. During the war, we had to cut back building, automobile production, and so forth. During the great depression which lasted throughout the 1930's, we had also built but little. Thus we came out of the war with a stock of houses, factories, machinery, automobiles and appliances that was far short of what our expanded population needed for a prosperity level of production and consumption.

Since 1946, we have come a long way. We have built enough houses to provide roofs for the families that were "doubled up" during the war, to house all the new families set up as we caught up on arrears of marriages, and by now to provide a little margin of vacant housing so that people who get transferred to another city can quickly find shelter. While many companies still have uncompleted expansion programs, many have a reasonable margin of plant, and we have provided a reserve of defense plant which may also take care of many civilian expansion needs. Our stock of automobiles seems fairly adequate in size (at least pending more road construction and a cure for parking strin-

gencies), and most of the pre-war cars have been retired, so that a period of low replacement needs is looming up. Where in 1949 there were still so many unfilled needs that building and durable-goods production barely showed the recession, it is quite likely that a recession now would involve sharp cutbacks in these lines.

Range of Possibilities

The range of possibilities for the next few months may be bounded roughly as follows:

1. At the upper end of the range, we may get continued full-volume activity. But inflation is probably off the map of reasonable probabilities *unless* there is a big jump in defense programs. Either new troop movements or a big program of continental air defense might quite possibly take shape, so this "unless" is no mere empty surmise.
2. The *average level* of activity for awhile ahead—say through the first half of 1954—is pretty well guaranteed by the sheer momentum of business and by such commitments as government orders, private construction contracts, and unfinished expansion programs that cannot be broken off at once. This average level is not at all apt to fall short of 1953 by as much as 5 per cent.
3. But even by mid-1954, the *rate* of operations could be off considerably if new commitments slowed down and order-books grew thin.

I do not apologize for this admission that I do not know what will happen, within wide limits. This uncertainty reflects the fact that many crucial decisions bearing on activity beyond the middle of 1954 have not yet been taken—or are wide open for revision. If certain key people and firms make decisions that point to contraction, this pattern of decision is apt to prove contagious. Many of the factors that will shape these decisions are over in the uncertain realm of international politics. It is not the forecaster who admits uncertainty, but the forecaster who claims to see the future clearly, who owes his audience a special explanation under this year's conditions.

How Bad Could a Depression Get?

Could a depression under present conditions get as bad as that of the 1930's? Despite all uncertainties, I can say with con-

fidence that a trough as deep as that of 1932–1933, or a dragging depression at levels as low as ruled all the way from 1931 through 1939, is out of the question. This is a commentary on economic policy.

Policy Errors of the 1930's

The trough of the great depression could never have reached the levels of 1932–1933 without an astounding series of policy errors—errors which today's Congress, administration and monetary authorities are proof against. Here is a list:

1. The Federal Reserve continued a tight-money policy for months after the downturn in the spring of 1929. In so far as this was an error, of course, it may be charged chiefly to the stock market, which continued its boom well into the recession. In our times, with a saner stock market, the Federal Reserve is apt to give us easy money in any situation that looks as if it might be a downturn, as it has done in 1953.
2. In 1929–1931 there was a conspiracy of self-deception among government and business leaders, who refused to admit they were in trouble. In our day of monthly unemployment estimates and anxious self-consciousness, this will scarcely recur.
3. An epidemic of bank failures ran for two years (through 1930 and 1931) before serious countermeasures were tried, and was not stopped until the spring of 1933. Federal Deposit Insurance probably will prevent any recurrence; if not, it provides a channel for countermeasures.
4. Despite much talk of public works by economists and the Secretary of Commerce during the 1920's, public works were not effectively used to combat the depression. A slight rise of federal works was outweighed by a fall of state and local projects; and in mid-depression when federal support of state and local projects was provided, it was found that many state and local engineering staffs had been disbanded in the name of economy. While few economists are satisfied with our present public-works machinery, there seems to be little danger of such a complete fiasco in any future depression.
5. Our sharp tariff increase of 1930 helped accentuate the depression abroad. While we cut our imports of goods, our

barriers did not shut out the financial panic of 1931, which was at least in part a reimport of the strain we transferred abroad in 1930. Although we may not be too wise to cripple our trading partners in future, we are scarcely likely to panic at the results to the extent we did in 1931, when the

6. Federal Reserve reimposed a strong tight-money policy when the economy was acutely depressed and getting worse.
7. At about the same time, the Treasury called for a big tax increase, and Congress voted heavy taxes on commodities. The fact that people have troubles enough in a depression without heavier taxes would not be overlooked by a present-day Treasury or Congress.

Admitting that each generation finds new mistakes to make, this list of errors in 1929–1932 is so broad that we can be confident it will never be matched in future recessions. It would not be hard, either, to compile an imposing list of errors of omission and commission in the recovery policies of 1932–1939, and to argue that, even if one group of politicians managed to devise policies that could reproduce 1932, their successors (of whichever party) could pull us out reasonably fast to a situation at least as good as 1939. In all this, I do not assume that politicians have been indoctrinated by the "new economics"—but merely that they are no longer prisoners of doctrines that call (notably) for tax increases when tax reductions would do more good.

Built-in Flexibility

Partly by design but more largely by accident, we have developed a number of arrangements that have what economists call "built-in flexibility"—arrangements such that merely carrying out the routine of an established policy means taking action to oppose a recession. At the same time, we have weakened the tendency of credit and banking to accentuate business upswings and downswings.

On the credit and banking side, there are of course still some dangers. Installment credit contracts pledge a good deal of future income to pay for past purchases. If incomes fall, this means a more-than-proportionate fall of current purchases. But this danger existed on almost as large a relative scale in 1929 as well; and, besides, the security loans of 1929 committed many people to putting a good slice of income in 1930 and 1931 into

"paying for a dead horse". On the whole, personal short-term debts are less likely to squeeze current spending power on a recession than in the 1930's. The same kind of finding holds for business loans at banks, mortgages, and corporate bonded debt. Weak spots exist. But they are not so serious as the corresponding weak spots in the financial structure of 1929; and, above all, they are in no danger of compounding themselves through bank failures.

On the side of built-in flexibility, the prize exhibits are unemployment compensation and the taxes on corporate and personal income. In case of a recession, there is an automatic tendency for people to draw more unemployment pay, and for the tax liabilities of individuals and corporations to shrink. Together with other tax and expenditure programs with a less degree of built-in flexibility, these arrangements stand to offset about a third of any shrinkage in gross national product.

Stabilization and the Deficit

An unpleasant way to paraphrase what I have just said is to say that a 10 per cent recession of gross national product (toward $40 billion in annual rate) would push the government toward deficit by some $12 to $15 billion. By the use of scare words, this can be made to sound terrifying. But looked at calmly, it is a common-sense arrangement.

Think of the position of any business firm in a recession. Sales are falling; perhaps unsold goods are piling up. To go on producing much more than can be sold risks bankruptcy. The only safe policy for the firm is to cut back output (or purchases, for a merchant) in line with sales—or further, so as to work off inventories.

It is largely this perfectly innocent and healthy response of operations to sales at individual firms that gives a business downswing its momentum. Each firm that cuts purchases cuts the sales of its suppliers. Each firm that cuts payrolls cuts the sales of the retailers who sell to wage-earners. When everybody tries to cut production down to match sales, the level of sales is undermined.

Built-in flexibility makes this process taper off instead of snowballing. When there is built-in flexibility of one third in the tax-and-expenditure system of government, a drop in output

cuts the spending power distributed by only two thirds of the fall in the value of output. As output falls, therefore, sales drop by less than output. A moderate reduction of output can bring things to a level where output has fallen below sales, and the downswing is no longer self-reinforcing.

This is no place to wrangle over the technicalities of built-in flexibility, or the related problem of the effects of recession on saving and on investment opportunity. But I can report a moderately optimistic general consensus of the economists working on these questions. Even if we took no active steps to oppose a recession, we would not oblige the Marxist forecasters of doom by generating a depression that could drive workers and farmers to despair. On the most pessimistic assumptions, the worst year of a depression in the near future could scarcely show output as low as 80 per cent of potential (that is, as badly depressed as in 1931). After the momentun of inventory reduction was absorbed, furthermore, a mere half of the present level of construction and equipment installations could apparently support a level of total output not much below 90 per cent of potential.

While short of disaster, though, such levels of output would spell serious trouble. A 10 per cent shortfall from the potential output of the United States represents a wastage of productive power almost as great as the total product of France. And we have to remember that even our mild business wobble of 1949 upset trade positions and currencies all over the world. The economic and political backwash abroad of a slump to 90 per cent of full production (let alone to 80 per cent) might necessitate a fresh wave of international rescue operations.

Built-in Flexibility and the Debt Limit

Our reliance on the stabilizing force of built-in flexibility implies that a large deficit could be financed if necessary. Present estimates indicate that even with continued prosperity the Treasury will find it hard to stay within the existing debt limit of $275 billion. Since the debt includes obligations to the Unemployment Trust Fund, an expansion of unemployment compensation contains an automatic debt adjustment. But a loss of tax revenue does not.

I am not one of those who feel the debt limit is an empty formality. By keeping the Treasury on a tight rein this fall,

Congress has registered a national concern with keeping the expenditure side of the budget lean, in a situation that still is one of full prosperity. But in a situation where a rigid debt limit would force the government to call for tax increases in a slump, to delay tax refunds or payments to government suppliers, or to cripple programs set up by Congress through wholesale discharges or cessations of procurement, I would count on Congress to see an increase in the debt limit as a common-sense measure.

Safeguards—Improving Built-in Flexibility

Built-in flexibility cannot suffice as an anti-depression policy. All it can do is to establish a higher floor for a depression, and ease the decline. For all that, improvements in built-in flexibility are worth an effort. There are three main areas—farm policy, individual income tax, and corporate income tax—which offer prospects.

On the farm side, it should be possible to agree on a policy that would reduce the size of farm benefits in prosperity while assuring a big growth of benefits in a recession. The best form for such a program is not easy to define; but we can say from experience that price supports based on parity are an unsatisfactory makeshift.

On the individual-tax side, the most conspicuous possibility is to provide quicker refunds of overpaid taxes to people who lose their jobs. This is one point at which English arrangements are ahead of ours. Harder to set up, but well worth the work, would be arrangements to relate a taxpayer's average tax bill over a stretch of years to his average income, designed to produce prompt refunds in a slump.

On the corporate-tax side, the response of the tax to a slump would be better if companies losing money could carry back current losses against past profits for three or five years instead of the single year now allowed. Such a change would reduce pressure to scale down plans for capital outlay in a recession, by reducing the danger of a financial pinch. Besides, if we had a stronger element of carry-back in the tax system, we could make better use of the idea of authorizing corporations in a recession to depreciate their new investments quickly. Under present tax law, such a concession might lead to actual postponement of

scheduled installations till the firm could be sure of profits to charge them against. With longer carry-backs, firms which had recently had profits could be sure of getting full benefit of depreciation despite uncertainty about future profits, and accelerated depreciation would become a reliable way to stimulate capital outlays.

Safeguards—Public Works

Since the war, highway and school construction has been held back in order to reduce inflationary pressure and to release key materials in the Korean military emergency. Even if full prosperity continues, some speed-up of these types of construction seems called for. In case of serious recession, a much greater speed-up would make sense. We might try, for example, to provide space for the oncoming bulge in our high-school student body as it happens, instead of waiting till overcrowding becomes acute, as we have on the whole while grade-school enrollment was growing.

To use public works to hold and reverse a recession, some central influence on their timing is essential. Projects for which blueprints exist and sites and financing are arranged can be started in a few months at worst. To some degree, the mere slackening of private construction will set up pressures at the state and local level that can speed up public works at this stage. But since coping with a recession is a matter of national concern, it would seem appropriate for the federal government to offer financial backing to local projects whose timing can be guided with a view to economic stabilization.

Safeguards—Preparations for Tax Cuts

In case of a slump, the market for consumers' goods can be supported by cutting taxes and leaving people more to spend. This involves commodity taxes (excises, stamp duties, sales taxes) and the personal income tax.

On the commodity-tax side, it should be possible to agree in advance on destination levels (preferably zero) to which our "nuisance taxes" will be permanently reduced when there is scope for tax reduction. In case of a slump, Congress could quickly decide what proportion of the excess of these tax rates over destination levels should be removed. In so far as commodity taxes are to be a permanent part of the federal tax system,

it might be well to replace our present mass of differentiated taxes by a general sales tax with a single rate. The impossibility of quick decision about changes in a complex rate structure, and the paralysis of Congressional tax committees while such changes are being considered, bar flexible use of existing commodity taxes.

On the personal-tax side, experience in 1948 and in 1950 has shown the feasibility of quick changes in withholding rates, with annual tax rates brought into line later. But it might be worth while for Congress to provide in advance for the printing of several alternative withholding tables (corresponding to different degrees of temporary abatement of standard rates), so as to be free to make a change effective on very short notice on such a date as April 1 or July 1, 1954, if sales to consumers were sagging seriously a few weeks beforehand.

A Basis for Confidence

In the end, any program for keeping the economy of the United States on an even keel must rest on private citizens. Goverment action can slant private decisions by altering incentives and by altering the flow of spending power. But it is private households that decide what products can be marketed, and private firms that hire workers, schedule production, and install plant.

If we succeed in holding future recessions within narrow limits, it will be because business men, investors and home-buyers trust that major depressions can be avoided—and by their own actions help justify their trust. But as we saw in 1929–1932, the national asset of confidence can be wasted by a policy that relies too much upon it. If experience in the early part of a recession shows the government's anti-depression policy to be inadequate and indecisive, the recession can go from bad to worse through loss of confidence. But if policy is so framed that it can keep a recession mild even though confidence wavers, we can count on confidence to rally and help recovery. In short, the only way to build confidence is by making substantive policy solid enough to earn confidence.

Remarks by the Chairman

Chairman Morgan: Thank you, Professor Hart, for a very comprehensive paper and delivered with a facility which I must envy.

Our next speaker is a naval officer by training, a manufacturer briefly, and now an expert in financial securities. Mr. Aubrey G. Lanston!

MANAGEMENT OF THE PUBLIC DEBT

AUBREY G. LANSTON
President, Aubrey G. Lanston & Co. Inc.

SINCE money is the means by which we exchange the products of labor and services our regard for it has a great deal to do with the condition of our economy. We hear money described as hard, soft, honest and otherwise, but the thing that counts is whether we trust it, that is, whether we believe the dollar will be worth as much tomorrow as today. No one wants money to be worth more by virtue of hardships wreaked on others through hard times, but we cannot trust the dollar if we think it is going to be worth increasingly less.

The government has a large responsibility for our attitude toward money which it may discharge in diverse ways. The execution of fiscal, debt management, and credit policies has considerable to do with the kind of money we have. These policies are not omnipotent but they are very powerful. Yet, no one of them can stand alone. They are interrelated and interdependent, and no appraisal can be made of one policy except against the background made up of the requirements for the other two.

Fiscal, Debt Management, and Credit Policies Are Like the Legs of a Three-Legged Stool

These three policies and their relationship to existing economic conditions may be likened to the legs of a three-legged stool which is being used as a seat by a watchmaker working at his bench. If one of the three legs of the stool is weak, it provides an uncomfortable support, and the watchmaker's concentration may be distracted from his task. Should one leg of the stool break, then, momentarily, the stool must be balanced on its remaining two legs. If one leg breaks, a greater strain is thrown on the other two, and the chances are good that the watchmaker will be dumped on the floor.

In like manner, if one of our three money policies is weak, this weakness tends to create weakness in the other two. Our economy can be tilted toward either inflation or deflation and eventually, like the watchmaker, it may be dumped to the floor.

Also, it does not make much difference in the case of the stool whether one leg is stronger or more securely fastened into the top than another, as long as all three are strong. The trouble comes when one leg is weak, and the same thing is true in the case of fiscal, debt management, and credit policies. Two may be eminently sound, but if the third is unsound or weak, concern is bound to arise over the trustworthiness of the dollar or the future economic stability. In either event, political expediency may impair attempts to strengthen the weak policy and thereby inject weakness into the other two.

Now I want to discuss *the forces that Treasury cash deficits and surpluses set up* in the bond markets and *those created by debt funding.*

Thereafter I want to say a word about *free markets for Treasury securities,* go over briefly *the situation as it developed during the first half of this year,* and then, with the aid of some charts, I want to talk about *the public debt* per se.

The Forces That Treasury Cash Deficits and Surpluses Set Up in the Bond Markets Are Important

I am sure that you know what these forces are but the point is so important I feel compelled to make it because we went through a long period when bond prices did not react normally.

Let us suppose that we have X structure of interest rates. This structure of rates will be made up, as you also know, by the yields offered on Treasury securities of all maturities, by the yields offered on corporate and municipal securities, and by the various interest rates charged on commercial loans, mortgages and the like. In sum total, these various and sundry credit instruments—public and private—may represent $500 billion of indebtedness and the total funds invested in them obviously would be a like amount.

Now, the biggest originator of debt has been the Treasury; so let us assume, for the moment, that all other forces that produce a prevailing structure of rates such as savings and investment and the demand for private credit are frozen momentarily. Then, if the Treasury is forced to finance *a deficit* of $5 billion, the market value of the credit instruments already outstanding must shrink to $495 billion in order to make room for the Treasury deficit. That is, they must lose about 1 per cent in their market value.

Conversely, if the Treasury were to have a $5 billion *cash surplus* which was to be applied in debt reduction, the market value of the reduced number of credit instruments to be outstanding must increase; that is, they must gain about 1 per cent in their market value.

Of course, this is a tremendous oversimplification but no amount of elaboration would change the facts. If the Treasury is required to add to the amount of its securities outstanding, it introduces a force which tends to cause bond prices to decline. If the Treasury is able to reduce the amount of its debt, it introduces a force which tends to cause bond prices to rise.

For a long time these forces were submerged by bond market conditions in which bond prices were held up or pushed higher because we lacked a flexible credit policy. It, therefore, takes time both to understand and to get across to a lot of people certain corollary facts. One, the large fluctuations in bond prices during 1953 have not been the results of undesirably free markets. Two, they were caused in the main by an inappropriate and large cash deficit during business boom and by the only appropriate responses that a sound and flexible credit policy and debt management can give to an unsound fiscal result.

The forces created by debt funding have some of the characteristics of Treasury cash deficits and surpluses. When debt funding is undertaken, double forces are generated by Treasury debt operations. Sometimes the two forces act in the same direction. At other times they offset each other. The power of each force varies, first, with its size, which is relative to the net demand and supply of the various types of Treasury securities, and, second, with changing conditions in the capital markets and in the general character of the existing business situation. By measuring the direction and power of these two forces under changing economic assumptions it is possible to reach certain firm conclusions about debt management.

For example, the best time for the Treasury to fund its short-dated debt is when it has a sizable cash surplus, because the retirement of short-dated debt with this surplus releases funds for other investment. This, of itself, might leave a net excess of investment funds which would seek reinvestment in Treasury and other securities. Simultaneous debt-funding operations would bring about a second decrease in the short-dated debt and,

unless the private credit demand were quite excessive, these two increments of debt reduction would assure the Treasury of a confident and receptive market for intermediate and longer-term bonds.

In similar fashion, the most difficult time for the Treasury to attempt to fund debt is when it must finance a deficit and the demand for private credit is strong. In this background, the Treasury can offer most nonbank institutions little incentive to increase their holdings of Treasury securities regardless of type, because private borrowers will bid aggressively for perhaps all or more than all of the available funds. Moreover, if the Treasury were to persuade the nonbank lending institutions to pledge some of their funds to it, a lesser amount would be available for private borrowers who then would try to outbid one another, and the Treasury, more strongly. The result would be a lower level for bond prices than otherwise would exist.

Further, it should be kept in mind that strong competition among private borrowers cannot be counted upon, as much as it used to be, to drive a sufficient demand out of the market to permit a redressing of the imbalance between savings and investment and demand. Today, taxes are high and a correspondingly large portion of the cost of borrowed money is borne by the Treasury. Therefore, it becomes more difficult to bring about a reduction in demand for money by increasing its cost. Money tends, more than it did in the past, to become *unavailable* before its *cost* becomes *too expensive*. As money begins to become unavailable the danger of disrupting the capital markets and of disturbing commerce and industry becomes enlarged.

There are all sorts of variables in this kind of a picture but, to me, it is inescapable that when business is good a Treasury surplus is the key to whether debt management can be as sound as all of us would like it to be. And, it becomes both difficult and hazardous to attempt to fund the short-dated debt if the Treasury does not have a good cash surplus and business is booming.

There are, of course, other situations wherein it becomes very easy to sell intermediate and long-term bonds. These would include times when the general demand for private credit is rather low and business is not so good or worse. How much funding then should be undertaken will depend upon how im-

portant it may be to keep lenders and investors under pressure to create a demand for mortgages and other forms of private productive credits.

What About Free Markets for Treasury Securities?

Last April Federal Reserve Chairman Martin made a speech in Detroit to which he gave the title—"The Transition to Free Markets". This talk became controversial largely, I believe, because many people judged it on the basis of excerpts appearing in the press. I thought it excellent and I believe that on a full reading most persons would agree.

Mr. Martin said, as I read his remarks, that the greatest good for the greatest number requires some regulation of our daily lives but such regulation should be the minimum that will do the job. He added that we cannot have absolute freedom in human affairs, and this was true of free markets.

In other words, free markets are not strictly free. They are subject to the influences of Federal Reserve credit policy and of debt management and are affected, as are both of these, by the results of fiscal policy, namely, the Treasury's cash budget. Anyone who thinks differently would find that he would lose substantial sums of money very quickly if he were to try to deal in government securities.

The term "free markets" is best used to contrast the present ability of prices and yields to reflect the judgments of the market place against what went on when the Treasury was dictating the rates at which it would finance and the Federal Reserve was preoccupied with supporting these rates.

Unless, and until, the Federal Reserve System finds it cannot comfortably conduct its open-market operations through the medium of transactions in Treasury bills, it should continue to avoid transactions in other types of Treasury securities. Once an excuse or the necessity arises to intervene in a market, it is only human to discover an increasing number of reasons for more and more intervention. In fact, when the normal functioning of a market has been thrown out of gear, its subsequent malfunctioning will seem to call for just such additional doses of intervention.

What applies to Federal Reserve open-market operations also applies to the purchases and sales effected for Treasury accounts—they should not be used for stabilizing purposes.

Anyone who opposes free markets of the type we have today is knowingly or otherwise an advocate of regimentation. Mr. Martin put it this way: ". . . dictated money rates breed dictated prices all across the board. This is characteristic of dictators. It is regimentation. It is not compatible with our institutions."

The situation as it developed during the first half of this year proved to be of the type in which debt funding was bound to meet with maximum difficulties. It is worth while devoting some time to it because it was an unusual situation if the goal of a trustworthy dollar is to be attained and maintained.

Business boomed with no visible let-up resulting from the Red peace offensive in Korea. The demand for bank credit was strong. Commercial loans underwent less than the usual seasonal contraction. Capital market activity was extraordinarily high.

Credit policy was definitely restrictive through mid-May. The first attempt of the new Treasury team to fund debt late in January met with only minor success. It became known that Treasury officials were nonetheless determined to carry through with a lengthening program although further attempts obviously would require higher rates of interest. This caused people generally, including would-be borrowers, to expect higher interest rates for all credits.

The cash offering of the 3¼ per cent bonds, early in April, has been held to be consistent with, and supplementary to, the then-existing credit restraint of the Federal Reserve. The cash offer of the 3¼'s was not the cause of the subsequent, swift downturn in bond prices. The exchange offer made to holders of the F and G savings bonds did contribute, because the favorable terms compelled many trustees to exchange and sell 3¼'s instead of maturing their savings bonds. There was not enough money around to absorb the additional supply.

The day after the books closed for cash subscriptions the Federal National Mortgage Association, which had been maintaining a secondary market bid for guaranteed mortgages, halted its buying of VA and FHA mortages. This presaged a further rise in the cost of mortage money. On the same day, nation-wide finance companies boosted the rates offered on their paper, the second increase in several weeks. It had

become obvious by this time that the availability of money would be reduced swiftly and the posted prime rate of leading commercial banks was increased to 3¼ per cent shortly thereafter, as a mad scramble to complete borrowing arrangements got under way.

In the second week in May, the Federal Reserve banks purchased Treasury bills in the market for their own account for the first time this year. During the last half of May, bills purchased outright and under repurchase contracts with dealers exceeded $300 million. This was followed by $900 million of such purchases in the first half of June.

While these developments were unwinding, the Treasury budget became a source of increasing trouble. By late March, it had become plain that income tax receipts would fall measurably short of Mr. Truman's January estimates. Expenditures were "in line" partly because of the economy program of the new Administration. April receipts confirmed the trend observed in March.

On April 9 the Treasury publicly stated it would need $2 billion to tide it through June 30—the close of the fiscal year. No reference was made to the needs of the summer. On April 23 the Treasury had to backtrack on this statement to say that it would need a larger sum. No estimate of the increased amount was provided. By mid-May the Treasury had raised $1.3 billion, of which $1 billion was from 3¼'s. During the last half of the month, the Treasury hit the bill market for $1.2 billion and in June it hit it for $1.3 billion more and in July for about $6 billion through comparable securities.

Some of the cash financing done in May was a surprise, namely, the offering of $800 million of tax anticipation bills on May 25. The market had no advance intimation of the offering. The Federal Reserve had been stepping up its injection of additional reserve credit but, as it turned out, not enough had been pumped in by this time. The selling climax in the bond markets came exactly one week later and was met head-on by bond purchases for Treasury accounts and by the massive purchases of Treasury bills for the Federal Reserve System.

* * * *

The Federal Reserve's performance during this period, and for the past year, has been extraordinarily good, as good as any in its history.

The management of the public debt throughout this period has not been perfect but it has been conducted along lines consistent with the eminently sound precepts set forth by the responsible officials. These deserve national commendation and support.

In view of the high levels of business activity, the excessive short-term debt and the likelihood of a large cash deficit, it was compelling on the Treasury to try to place its debt outside of the banks. This could be promoted, in the attendant circumstances, only by pricing its issues attractively and contributing to the inevitable increase in money costs.

On the whole, the situation as it developed during the first six months of this year vividly outlines two things: first, the interrelationship and interdependence that exists between fiscal, debt management, and credit policies, and the manner in which weakness in one promotes weakness in the other two; second, the necessity that the Treasury have a sizable cash surplus when business activity, incomes and employment are high.

Management of the public debt has to proceed from sound principles, but working out a reconstruction of the debt is like drawing the plans for a house while trying to solve a jigsaw puzzle. You have to know what kind of a house you want and you cannot work out the puzzle unless you use all the pieces. It is doubly tough to do both at once. I have brought along some charts to help show you the kind of house we have built and what the pieces of the jigsaw puzzle look like.

Chart 1 shows the growth of the total interest-bearing Treasury debt from 1930 through September 30, 1953. You can see that there are various segments and that only about three fourths of the total debt is held by the general public. This is in the form of savings bonds, savings notes and other types of securities. It amounts to about $200 billion of the $275 billion total debt.

Approximately one third of the publicly held debt is of the demand type, namely, savings notes and savings bonds. About two thirds consists of securities that are marketable in one form or another.

You can see that the debt held by the general public has decreased from the peak amounts held in 1946. The marketable portion has decreased faster than the total which includes savings bonds and notes.

CHART 1

TOTAL INTEREST BEARING TREASURY DEBT

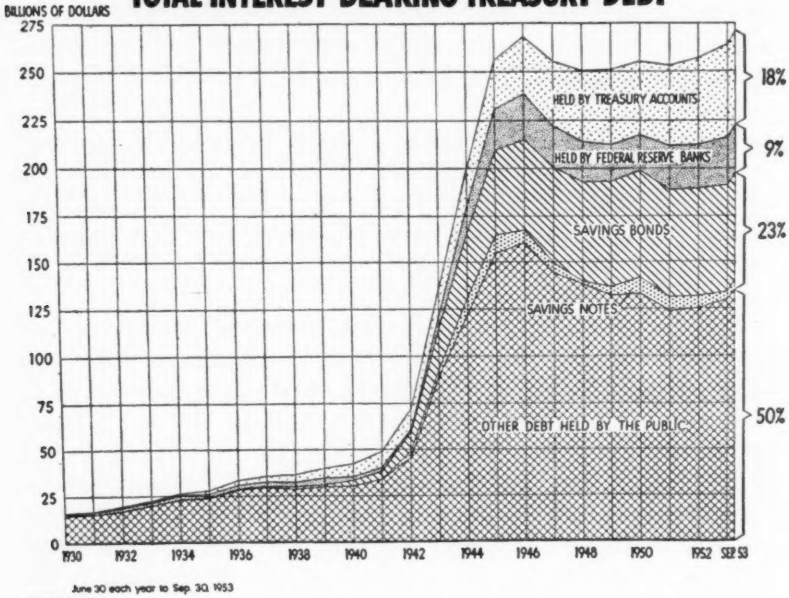


CHART 2

CHANGE IN VARIOUS TYPES OF TREASURY INTEREST BEARING DEBT AT SELECTED INTERVALS

Chart 2 shows the composition of the debt in a little different form.

At the left is the debt held by Treasury accounts.

Second from the left is the remainder, that is, the debt held outside the Treasury. This includes the holdings of the Federal Reserve System.

Then, on the entire right half of the chart is the debt held by the general public. This is broken down into holdings of savings bonds, which are represented by the columns to the right of the center, and into holdings of marketable or convertible securities which appear on the far right.

There are five bars in each of the four groupings on the chart. These show the amount of such debt outstanding as of selected dates beginning with June 30, 1941, the left-hand bar in each group, and ending with September 30, 1953, the right-hand bar in each group.

Future changes may be as follows:

> Holdings of Treasury accounts may be expected to increase unless legislative changes are enacted.
>
> Holdings of the Federal Reserve Banks are more likely to increase than decrease over a period of years, but this is less certain than in the instance of Treasury accounts.
>
> If a net increase occurs in the combined holdings of the Treasury and the Federal Reserve, it would produce a decrease in the holdings of the general public unless the total debt were to increase at a faster rate.
>
> If the total debt were to decrease, the holdings of the general public would decline quite rapidly, the principal loss being at commercial banks.
>
> If the public's holdings of savings bonds and notes were to increase while total public holdings remained unchanged, the amount of marketable holdings would decrease and vice versa.

Chart 3 will give you an idea of the changing shape of the debt as of the same selected dates. I should point out, however, that in this chart we have dropped out the savings bonds. These are a rather separate problem of debt management. We have added to the marketable debt that matures in one year the amount of the savings notes outstanding.

CHART 3

MATURITY CLASSIFICATIONS OF THE DEBT HELD BY THE GENERAL PUBLIC EXCLUDING SAVINGS BONDS

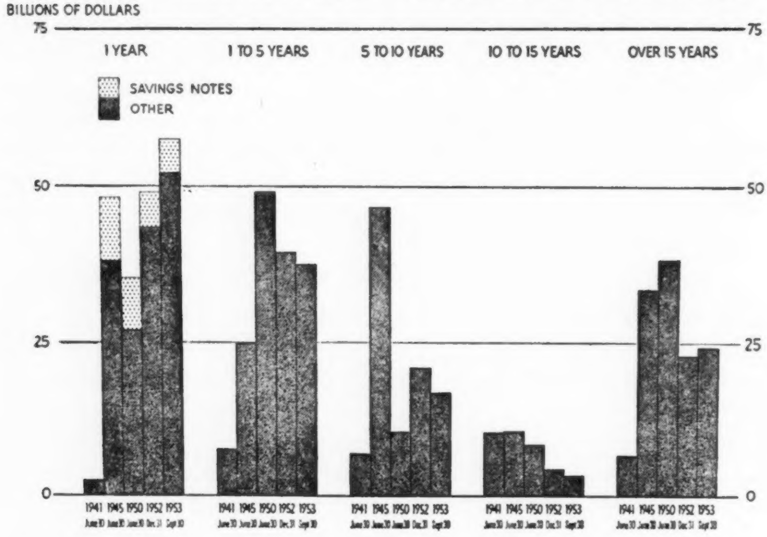
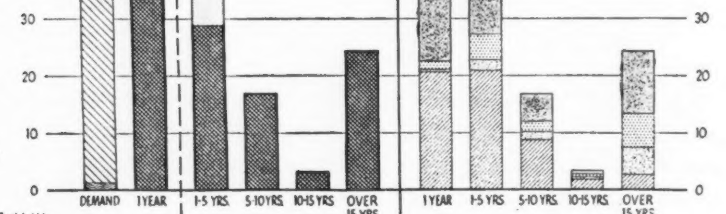


CHART 4

DISTRIBUTION OF INTEREST-BEARING DEBT HELD BY GENERAL PUBLIC



	DEMAND	1 YEAR	1-5 YRS.	5-10 YRS.	10-15 YRS	OVER 15 YRS.
% of Total held by General Public	30%	28%	19%	9%	2%	12%
% of marketable, convertible and Savings Notes held by General Public	–	41%	27%	12%	2%	18%
% of Total int bearing	22%	21%	14%	6%	1%	9%

Each main grouping on the chart represents a different maturity segment with five bars showing the amount of such debt outstanding as of the same selected dates used in Chart 2.

Moving from left to right, the main groupings are for debt maturing

In 1 year
From 1 to 5 years
From 5 to 10 years
From 10 to 15 years, and
Over 15 years.

We lack time to go over this chart but I believe you may find it interesting to study the changes that have taken place in the shape of the debt from one selected date to another.

Your attention is called to the fact that, as of September 30, 1953, the debt maturing within one year was the largest of any of the selected dates. That is why the Treasury must be concerned about debt reconstruction.

Chart 4 is a double one. The left half shows the shape of the debt as of September 30, 1953 on a larger scale than was shown in Chart 3. The right half of the chart shows the ownership of the marketable debt by major investor classes.

From the left-hand portion you can see even more clearly why the Treasury is concerned. We brought back into this picture the savings bonds because of their demand liability. They appear on the far left. To the right is the one-year debt plus the savings notes. Then moving over to the right you will see the amount of debt due

From 1 to 5 years
From 5 to 10 years
From 10 to 15 years, and
Over 15 years.

You may note that the total of the demand and the one-year debt is almost 60 per cent of that owned by the general public.

You may also note that the total marketable debt due within five years—the total of the second and third columns from the extreme left—is almost 70 per cent of the total marketable debt held by the general public. This is an excessive proportion even though it is only 35 per cent of the total interest-bearing debt outstanding.

Now on the right half of the chart you will find that almost all of the one-year debt is held by "Other" investors, including business corporations, and by commercial banks.

As far as we can estimate, about one half of the "Other" holdings belong to business corporations. The bulk of the remaining holdings of "Others" belong to about 7,000 banks whose ownership is not reported.

The point is that almost one third of the total one-year debt held by the general public is in the hands of business corporations. Such holdings may hardly be said to be susceptible to funding into intermediate and long-term bonds. This debt ownership of maturing securities may explain the Treasury's preference for "basket", or double, refunding offerings.

Even so, the one-year debt is apt continuously to be held largely by business corporations and commercial banks because investors, such as insurance companies, savings banks, and so on, follow a practice of selling securities as they shorten in order to reinvest elsewhere. They rarely wait for the Treasury to do their refunding for them.

The problems originating from the ownership of these short-dated issues would be lessened if the commercial banks were permitted to pay interest on demand deposits. Then, a substantial portion of the holdings of business corporations would be sold to the banks and the proceeds turned into demand deposits. The resulting ownership would make it easier for the Treasury to spread out the excessive amount of one-year debt over a somewhat longer period of up to five years and this would give it more elbow room for other longer-term funding.

The transfer of maturing debt from the commercial banks to nonbank investors is apt to be a slow process. This is because many of the nonbank investors will wish to maintain a diversified portfolio. Treasury bonds are the prime security and offer a commensurately less attractive rate of return. These investors will not be willing to increase the percentage their government holdings bear to their total assets unless they lack other more remunerative investment outlets. Therefore, the annual rate of their demand for long-term Treasurys will be some fraction, probably a small one, of the growth in their total assets.

Of course, there are a number who can invest only in Treasury securities, and these are one of the best sources of demand for

such new funding offerings. However, when everything is added up, it appears that over a period of five to ten years, the Treasury may expect only about $1 to $2 billion per annum to become available, in the average, for the purchase of intermediate and long-term Treasury bonds by nonbank investors.

In closing, I would like to make briefly a few additional points. Both Treasury and Federal Reserve officials have talked about the need for a broader market for Treasury securities. The Treasury can help in this in several ways. I shall mention two.

A broad market develops from large activity in the thing that is being bought and sold. If the activity is small it cannot have a broad market. At the same time, I am sure that neither the Treasury nor the Federal Reserve is anxious to increase the gross number of transactions in the market. That would prove nothing. The point, therefore, is that if we are to have a broader market for Treasury securities, a greater portion of the total transactions that take place should be able to flow through a smaller number of issues. We have too many different Treasury issues to be able to made a broad market in most of them at the present time.

The markets in Treasury securities are made largely by what are known as primary dealers. A primary dealer is one who is willing to buy *or* sell at the prices he quotes for each of the different Treasury issues outstanding. For example, if a primary dealer makes a market to a customer of 98 16/32 bid and 98 18/32 asked, it means that he is prepared to buy *or* sell, whichever the customer wants to do, in reasonable amounts. The dealer may not know at the time where to resell the bonds he bought (or where to repurchase the bonds he sold). Yet, on his next call he may find a buyer. But is it for the securities that he bought? Frequently, the answer is no. So the dealer becomes locked in by owning bonds he cannot sell and by having sold bonds he cannot buy.

The extent to which the dealers may get tied up in commitments such as these will be much larger if $10 billion of Treasury securities are issued in the form of five different issues than if they become outstanding in the form of one issue. In the first instance he has to make five markets and he may end up with five short and long commitments that will net him very little profit for his trouble and risk. In the second instance, his purchases and sales would result in reducing his commitments.

There are certain minor pros and cons involved in the desirability of opening up outstanding issues when the Treasury is engaging in a funding offering and certain others when it offers for cash. I do not believe these offer serious problems. In any event, the Treasury would contribute greatly to the development of a broader market for Treasury securities if it moved to build the debt in the form of fewer issues outstanding in large amounts instead of continuing to enlarge the number of issues, many of which are relatively small.

This leads me to a second way in which the Treasury may be helpful in developing a broader market. The Deputy to the Secretary of the Treasury seems to be inclined along these lines if I rightly judge references he has made with respect to the short-term debt. He has pointed out that the Treasury used to have only four issues maturing each year. These matured on the quarterly income tax dates. This, of course, excludes Treasury bill issues. The result was the Treasury came to market to refund debt only four times a year. By contrast, the Treasury will have come to market this year nine or more times. What I have said earlier about working toward a smaller number of larger issues in general applies with greater force to the one-year debt. Moreover, we could reconstruct the one-year debt along such lines within the coming year.

On each occasion when the Treasury has come to market this year, it has engaged in consultations and meetings of one kind or another over periods of from two to six weeks before it actually made its offering. The result has been that the market has been made unnecessarily subject to grapevine stories, rumors, and conjecture. At times, it has been almost impossible for dealers to make good markets in the securities affected, or throughout the whole range of the Treasury list, because they could not be sure what story tomorrow might bring from what might be termed a responsible source. The Treasury market would have to "stand aside" less if there were less frequent financing and a shorter consultation period before each financing.

On debt refunding I would like to introduce a thought that might speed up the process of debt reconstruction. As you can see from the right half of Chart 4, a fair amount of 1–5 year and 5–10 year debt is held by mutual savings banks and insurance companies. This also is true of other nonbank investors. Under usual practice, this debt eventually will become of one-year

term before attempts are made to fund it, but by that time these investors will have sold these holdings. If the Treasury were to make exchange offerings, particularly to these nonbank investors, under which some of the 1–5 year debt could be exchanged for long-term bonds, I believe such exchanges would be received with enthusiasm. This assumes, of course, that the terms offered are in line with market conditions. By such advance refunding the Treasury might reduce its problems of "tomorrow". Canada recently has done some such refunding.

In summation let me repeat the points I have tried to make.

In working out a reconstruction of the public debt the Treasury is faced with difficult problems arising from debt ownership because the short-term debt is apt, at all times, to be held largely by business corporations and commercial banks. The potential transfer of maturing debt to nonbank investors in the form of long-term bonds is unlikely to exceed an average per-annum rate of $1–$2 billion.

There are several ways in which the Treasury can promote the development of a broader market for Treasury securities. The most important is to build the debt so that we end up with fewer issues that are outstanding in large amounts instead of more issues that are outstanding in small amounts.

One way to reduce tomorrow's debt management problems, and to speed up the reconstruction of the debt, would be to make refunding offerings to nonbank institutions in exchange for issues that have a term longer than one year at the time.

Fiscal, debt management, and credit policies have considerable to do with the kind of money we have, and weakness in any one of these injects weakness into the other two, thereby imperiling the trustworthiness of our money.

Under a flexible credit policy and free markets, Treasury deficits are a force which tends to cause bond prices to decline and Treasury surpluses are a force which tends to cause them to rise. Free markets in Treasury securities are not strictly free, but are subject to the influences of credit policy, debt management and fiscal policy. The situation that developed during the first half of this year, during which bond prices declined sharply and interest rates increased substantially, should be attributed primarily to the rapidly increasing cash needs of the Treasury. This was a part of the inheritance from the weak fiscal policy of earlier years.

REMARKS BY THE CHAIRMAN

CHAIRMAN MORGAN: Thank you very much, Mr. Lanston, for a very impressive speech.

The next speaker is an old friend of mine whom I have known not only in numerous different situations in the United States, but in other countries, too. Mr. William R. Herod, President of the International General Electric Company!

FOREIGN TRADE—MUST WE BUY TO SELL?

W. R. HEROD
President, International General Electric Co.

IT is a great pleasure to me to participate in this session of the Fall Meeting of the Academy of Political Science. The session's topic—"Firming Up the Economic Arch"—is part of the meeting's theme "The American Economy, Keystone of World Prosperity". My colleagues are discussing principally measures national; my assignment is international, with the query "Must We Buy to Sell?"

In answer, let me say at the outset: "Yes, we must buy to sell." The question is: "How much must we buy?" For, with unequal distribution of resources and skills among individuals and countries, trade is essential for high living levels. And the very word "trade" connotes a "two-way street". Also America's largest international transactions are goods and services "bought", and those "sold".

On the sales side, the products of our farms and industries have been exported from our earliest times. And in the last dozen years American facilities, employment and incomes have expanded with increased exports of goods and services. The beneficiaries here—workers, farmers, businesses and public—are vitally concerned with the maintenance of a strong market overseas as well as at home, in the national interest and for their own prosperity. They desire to maintain and if possible expand their sales and be paid in dollars. They desire to keep open the door of opportunity for sales abroad, with benefit from such sales. But they currently see their sales abroad limited by dollar shortage, foreign import controls, and protectionist policies.

The question "Must We Buy to Sell?" emphasizes "sales", seeming to imply that sales are our chief desiderata. Granted we want to sell; nevertheless "buying" represents the acquisition of wanted items, the satisfaction of needs, and it frequently enriches the economy as much as "sales". In many countries exports are urged to pay for imports. We Americans regard as natural our desire to sell; we also believe that our export

sales are advantageous—to ourselves, to our country, and to the purchaser. We frequently are mute as to the benefit to our individual convenience, to our pockets, and to our national economy from importing items less readily available here or available at lower cost from abroad. But these benefits are also real. Our industrial structure and our consumption are fed, and their level maintained and expanded, through domestic production plus imports. A telephone contains materials from many lands. Our morning cup of coffee represents an import. And even with synthetic production, we use great amounts of imported rubber in the tires of our automobiles. In copper, oil and iron, we have been self-sufficient, even major exporters; but now we import to supplement our own resources. These imports are a valuable addition to our economy wherever domestic alternatives are either not available or not available at economic levels. And the same applies to other nations, sometimes even more acutely. For example, a substantial proportion of Britain's foodstuffs must be imported; without them many British would have to leave; the British national aegis to export is to pay for imports.

But some here as well as abroad see risks in importing. They favor importing only essential needs not within domestic capabilities at other than excessive cost; and they are willing to accord protection in support. Some see in imports the displacement of national labor and, unless the product cannot feasibly be produced locally, a restriction of opportunity; with a "Sword of Damocles" hanging over price structure and profits. Such is sometimes the case, and certainly the thought finds acceptance here and in other countries in times of recession.

But there should be a "mean" in our philosophy. Imports are not unreservedly beneficial, nor are they in principle damaging; they can be either, or in between, depending upon circumstances. Almost everyone everywhere favors needed imports not otherwise procurable. But beyond this point unanimity fails. For it is hard to define "need", and difficult to specify what higher price—in money, effort, protection or sacrifice—is proper for a specific domestic product as compared to an import. Individuals and groups have different views on these matters. But without analyzing these now, let us see where we Americans currently stand in our export and import of goods and services, not as items alone, but in relation to an over-all picture.

Now any trade—domestic, export or import—is motivated by a "want" or "need", resulting in "demand". And the satisfaction of "demand" from one source as compared to another (if alternatives are available) is determined principally, first, by economic factors such as availability, competitive advantages (that is, cost, delivery, acceptability), capacity to pay, and so on; and, secondly, by policy considerations such as security, political objective, protection, preferences, and so forth. Sometimes these factors and considerations reasonably accord; frequently they do not. In domestic trade, the economic factors usually predominate. In international trade, policy considerations weigh heavily; frequently, though by no means always, they control. In a peaceful world, with cupidity and prejudices reasonably controlled, the factors and considerations of international trade could approach those applicable to domestic trade. But such is not our world. For we do not have peace; also cupidity and prejudice are almost universal, and perhaps less or at least differently controlled in international transactions. For example, with world division, policy considerations more than economic free play have reduced East-West trade to only some one-third its pre-war volume. And policies as much as economic free play have created the world's financial compartmentalization—with a dollar area, a sterling area, an EPU area, a ruble area, and others—in place of a world, or at least a free-world, multilateral trade and payments system so necessary for continued improvement. Policy considerations in aid, grants, and so on sustain our present export level; and policies abroad and here limit our sales; also they affect our imports.

For, with natural resources, a wide availability of American goods and services and less interference with our supply, and with elements of enterprise and dynamism making possible our remarkable expansion of production, the world's demands upon us and our supply to the rest of the world during and after World War II have been enormous. Our war and post-war exports have been abnormally high in relation to the world's exports and to our gross national product. The world abroad could not possibly have been reconstructed so rapidly without our goods and services. And it could not pay dollars for the amounts received. Even in the last few years, probably one third or so of our goods and services exported have been paid for by the American taxpayer, through aid or government loans.

Even with this, and the prevalence of import controls abroad, there has been, and in spite of recent improvement in foreign reserves continues to be, a "dollar shortage" limiting purchases, though less acute now than before. Dollar shortage since the passing of our own scarcities and even up to the present has been the principal deterrent to even higher United States exports. It has also been the stimulant and become the excuse for protection in various forms. For until recently our post-war exports encountered little foreign competition. With almost everything in demand—food, raw materials and finished products—and insufficient alternative supply, our own availability of goods and services for export and the priorities of need of various foreign countries have determined the pattern of our exports; whereas total dollar resources available for payment, including United States aid, determined their ceiling. Now with reconstruction abroad, non-American products in increasing volume are coming on the markets; alternative availability and competition are now present and dollar purchases are controlled. The pattern of our exports is hence changing, military grant items have increased, but nonmilitary exports have decreased some 15 per cent in the last year.

But science continues to develop new products. And our production techniques with the increasing power and investment behind each worker are national assets, particularly where mass production is concerned. These and a fortunate possession of natural resources are "leadership" factors. They yield to us earlier or greater availability of a widening field of products and services, with widening employment and economic expansion. In many lines they also yield both acceptability and reasonable costs in international markets—frequently competitive as to price even after alternate foreign supplies become available. Such goods and services might be called "export-positive". They are the items for which a sound and widening export demand would normally be expected, until corresponding goods and services are produced abroad, competitive as to acceptability, quality and price, or unless they are otherwise limited. Sulphur as a mineral, automobiles and movies are examples of lines "export-positive" for the United States. They can be produced in surplus to our own demands, sold competitively as to price, with high acceptability abroad, if foreign dollar resources and

policy permitted. But currently the sales of many of our "export-positive" items for which there is a real want and even need abroad are drastically limited by dollar shortage, and in cases by protectionist barriers or foreign import controls, particularly where the importing country regards them as either "luxuries" or less essential than other dollar wants.

In my opinion there are and most probably will continue to be enough American "export-positive" lines wanted by the world to insure a high export demand for our goods and services unless "policy" of importing countries intervenes. For, except as limited by dollar shortage, recession or policy, if controls in the way of exchange, quotas, and so on could be liberalized leaving only present tariffs here and abroad as regulators, the commercial demand for both our exports and imports would increase. In my opinion the demand for our merchandise exports would far exceed the level of our present nonmilitary exports of some $12 billion a year, and perhaps exceed the dollar value of our total exports of some $16.2 billion which includes unrequited items and unilateral transfers, military and other—this because of our present lead in product availability and productivity, with an expected continuation of our dynamism and enterprise in widening our resources and product field with further increased productivity. But to maintain such expanded level on a commercial basis, we must continue to increase productivity to keep our costs competitive. If we lag either in widening our product field or in productivity, the world abroad will justifiably buy other goods in preference to ours, independently of protective measures. The dynamic of our exports is production of goods and services which others want, and of such acceptability, quality and price as to win the business against alternatives. These are the same factors which are basic to our prosperity, domestic employment and export demand; and more importantly as our economy and exports involve more "labor intensive" products.

But in fields where we have no or insufficient "leadership"—that is, technical, novelty or productivity—with a high labor content at our wage levels without compensating productivity as compared to abroad—as is the case in many things more or less "built-to-order", for example, ships, structures, and so on—our competitive position in international markets is less

favorable. We have been exporting in this field because of foreign need and lack of suitable alternatives. But now, with foreign reconstruction, we are losing export sales in these fields to foreign competitors, who in turn are widening their product availability, and now underselling us in these lines. And in certain of our historically "export-positive" agricultural lines we are losing position. Here our domestic price support policies as well as foreign dollar shortage may have contributed to our losing export position in some lines, for foreign production at costs less than our price or more readily payable in other than dollar currency has been stimulated. For example, our cotton exports have shown a decisively decreasing trend over the long term, in spite of increased consumption abroad. Active competitive forces are hence now at work, altering our export pattern and reducing demand on us for such non-leadership items. The full effect has probably not as yet been felt. Additional foreign dollar availability would have little effect upon the maintenance of non-leadership export sales, except as "policy" (subsidy or aid) would assist. Hence, for items with insufficient "leadership" to be "export-positive", demand for our exports may be expected to diminish, with or without dollar shortage. And in certain cases American import demand may even develop, except as we resort to further protection here.

A substantial item in our recent merchandise exports has been military equipment and other goods directly paid for by the American taxpayer, which for reasons of security or policy we have been willing to grant and which foreign nations have accepted. If tension decreases with greater prospects for security, these grants and their corresponding exports will likely be reduced. Policy, ours and the recipient nation's, governs such exports today. But the American taxpayer hopes the world situation will some day permit reduction of this burden, and likewise foreign nations generally would like to be independent of these grants from us. On the other hand, with no increase in world tension, if such exports had to be "sold" in competition to other demands on various foreign countries' dollar resources, I should estimate that perhaps three quarters or more of them in the particular bracket would disappear from our export picture, with changes in the security build-up and trade which we might or might not like.

It is accordingly seen that our present exports are high; they contain a substantial element of "policy-inspired" transactions paid for by American taxpayers. They likewise have contained items where our availability and foreign needs have resulted in an American export order, but which under today's and expected future conditions would probably go to foreign competition. If the world becomes more peaceful, these trends would reduce the foreign demand on us for such types of exports. Against this, however, there are currently severe limitations on our "export-positive" lines—for example, automobiles, refrigerators and certain agricultural products—where demand is definite but exports are limited by dollar shortage or by policy considerations in the importing countries. The world may be expected to continue to want such "export-positive" items, subject to availability of dollars and "policy". These latter will set the ceiling. Policies abroad could establish a purchase ceiling within or below a given availability of dollars. The marginal dollars could go to building reserves until considered adequate, then for investment in America and increased travel and so on, with purchases still restricted. Such has actually taken place in the twelve months of fiscal 1953 when foreign gold reserves and dollar holdings increased some $2.3 billion, our nonmilitary aid being some $2 billion. But other than to build adequate reserves and service foreign investments in their own countries, the bulk of whatever dollars are available would most likely go into demand for our goods and services. Otherwise a foreign availability of products greater than at present is implied, together with a considerable readjustment abroad in the politico-economic-security field. Such may be the case, but if we have, as seems probable, reduction in policy-inspired nonmilitary aid and no greater imports or government foreign purchases for use abroad, a decrease in dollar availability would follow. Then even with decreased exports in our less competitive lines, I think we would find foreign demand for our "export-positive" lines pushing up to the limit of dollar availability with continuing though perhaps lessening controls to insure reserves. If we want to see our nonmilitary "export-positive" sales maintained or increased, we will have to maintain and increase dollar availability abroad. And to maintain this we must maintain our imports; to increase we must increase our imports. This would then permit fewer con-

trols and more latitude for individual choice, although protectionism abroad as a policy will probably not die quickly. Exclusive of our military aid, the United States in the last year has been just about in dollar balance on current account with the rest of the world. This has resulted from increased American imports; a reduction of approximately 15 per cent in nonmilitary exports with severe controls abroad; and American government purchases abroad of some $2½ billion in the year of goods and services for foreign use, including supplies, some offshore procurement, and soldiers' pay spent abroad. Dollar availability abroad derived from American payments is principally due to: the import of goods into the United States; the private payment for services received, including travel, transportation and private gifts; government purchases of goods and services for use abroad as mentioned above; the outflow of United States private capital; and United States loans and grants of aid. These have aggregated in recent years approximately $20 billion per annum, the chief item being imports, which in the fiscal year 1953 totaled almost $11 billion, considerably more than a few years ago.

Now the bulk of our imports represents raw materials and semi-finished goods to which we add value in processing. The total value of our imports has varied cyclicly with, but in the long run with a decreasing percentage relationship to, our United States industrial activity. Our imports also have progressively, and not altogether through happenstance, developed since the war a more North-South or Western Hemisphere component than before. This has altered the areas of foreign dollar-earning capability. And without a world multilateral payments mechanism, it has hit some countries. For Canada and Venezuela the result has been favorable. But for certain European and Asiatic countries the reverse has been true; for they have been less able to gain sufficient dollars directly or through triangular trade. As our industrial activity expands, our imports tend at first to expand more than proportionally. Similarly with decreasing industrial output here, our imports tend to decrease more than proportionally. However the initial tendency to more than proportional increase in imports with rising industrial production has historically, after not too long a period, been limited naturally or arbitrarily by the development of substitutes, local supplies, tariffs, quotas, or restrictions; so that, over the

long term, our import trend bears a decreasing percentage relationship to our industrial activity.

This pattern could alter with the increasing inadequacy of our own natural resources or with a change in our philosophy and policies with respect to imports or protection. But some of these characteristics of our economic behavior, particularly our seemingly arbitrary imposition of protective measures, even in good times but more noticeably in periods of recession, greatly concern foreign business and nations abroad who by experience are well aware of the multiplying effect on their payments positions and their own domestic economies of fluctuations in our economic activity here. The maintenance of prosperity here, reasonable stability for our tariffs, and the elimination of our quotas are three desiderata to those abroad; and far more important in my opinion than our tariff level if not unreasonably excessive. For foreign business makes its plans contemplating marketing problems. And they have increased their sales to us considerably in the last few years. But if difficulties are arbitrarily increased, losses are sustained through developing a market then cut off or restricted; also the foreign exchange positions of the nations abroad are then adversely affected, resulting in pressures for further controls on their imports and exchange, in order to balance out. This in turn further contributes to recession, unemployment and currency problems abroad. We must not forget that devaluation of the pound, franc, guilder, and so on followed our even short-lived recession of 1949. Another devaluation forced on them by recession here or by appreciable closing of our market would have serious economic and political effects abroad and would further handicap our export possibilities, and tend to force nations abroad into regional groupings with more difficult compartmentalization of the economic world than before.

To the extent Americans, and Canadians also, invest abroad, the exchange situations may be ameliorated and dollar availability abroad increased. But with world division and uncertainties deterring American private individual investors to put their money overseas and with the expanding American—and Canadian—economy, having relative security and earning power attractive to both Americans and non-Americans alike, it would not appear to me that the outward flow of investments would be sufficient to solve the problem.

American corporate investment in the extractive industries and direct investments in manufacturing by companies having a stake in foreign markets have been flowing in spite of world tension and risks; these have gone principally into dollar-producing investments with emphasis in the Western Hemisphere. But private noncorporate investment is low. And the combination of private and corporate investment was less than $\$1/2$ billion in fiscal 1953, which though helpful is not high enough to effect equilibrium at a level to permit trade and exchange barriers to be lower. In fact it is less than one third of American income on foreign investments in the same year. Unless and until world tension is reduced and a better climate abroad is evident, private dollar capital flow outside of North America is expected to be at low level. And we must note that foreign gold and dollar assets in the United States have in themselves increased appreciably from their post-war lows.

The principal other item in foreign dollar availability is the private payments for services and gifts, including travel, transportation and remittances. Our travel expenditures abroad exceed that of foreigners here, both having increased tremendously. Our payments for foreign transportation services are heavy but balance-of-payments-wise our receipts (including air travel) in the first half of 1953 apparently exceeded payments. And the combination of all items in this bracket (other than private investment income) has been almost exactly in balance with corresponding and other services exported in the last two years. Increases in our travel abroad can be envisaged, with foreign shipping and now aviation actively competing, and a net balance on this over-all account should appear, but probably not too soon in appreciable magnitude.

From these considerations a free-world balance with the dollar area, although attained over the last year or eighteen months on current account, does not, in my opinion, appear likely soon or without travail with unimpeded but requited flow of "export-positive" items. Of course a balance will be attained. But with what restrictions, what controls, and at what levels? To remove the restrictions and allow latitude freely for imports and exports and other uses of funds both here and abroad would require many and not always painless adjustments both for us and for foreign nations. These adjustments—which are not

always painless—are the real joker. At present the balance on current account is being attained with foreign nations restricting their dollar imports, in some cases even where no alternative supply is available. We do not like this. Further we, through quotas and various steps, have limited imports. And foreigners do not like this. To solve the problem we and our friends abroad must jointly adopt and pursue sound domestic as well as international policies. This is difficult in democracies, for it involves sovereign national action tempered by a consciousness of international economic interdependence, with a readjustment of outlook as to the movement of goods, services, capital and people even across international lines. But we should endeavor to solve it as comprehensively as possible within the widest range of countries which we can reasonably expect to be friendly and peacefully disposed. If we could get convertibility even on a nonresident current-account basis with liberalized trade between the dollar and sterling areas it would be a tremendous boon. This may not be expected too quickly, but progress may be possible.

This is no easy problem, soluble by either "free trade" or alternatively "high protection". It will require many approaches. In my opinion it may take some years to attain any generally acceptable solution. And if there should be a depression in the United States, foreign dollar availability would decrease and imbalances would be accentuated through reduction of our imports, foreign investments, and so on, and the problem will be much more difficult to solve. But the problem is not insoluble; progress has been made. And if we and others will be willing to accept relatively more imports if they are really economically sound, particularly from friendly countries, we can advance our own consumer interest, have an economic pattern and level of exports, have more stability to the employment they represent, and contribute to a more stable economy for ourselves and the free world. But tariff and quota adjustments must be done *selectively*—not at one fell swoop nor across the board, and not in such fashion as would damage American strength, so necessary to the free world at this time. We still have, in our own import quotas and internal price supports, some serious departures from our professed ideals and our advice to others on the advantages of competition and free markets,

and these gravely handicap our own spirit of enterprise and the interests of countries whose friendship and respect we want and may need but which we still jeopardize. But we have gone a long way in the last score of years.

This calls for reciprocity. Other nations also must endeavor to so conduct their affairs as to be able to and then actually reduce their trade barriers also. Together we must work toward the goal of a world-wide multilateral trade and payments system, with maximum convertibility and minimum controls; otherwise our more or less separate truncated economies operating respectively within a dollar area, a sterling area, an EPU area, a ruble area, or other compartment, with all sorts of restrictions and controls limiting transactions between such areas, will not prosper. Perhaps we Americans could work over to a program involving selective determination of first the forms and second the minimum levels of protection to be applicable to various goods and services, raising some if needed, keeping some and lowering some, and then "bind" ourselves, in consideration of appropriate engagements on the part of others, to impose no additional protective measures against those with whom we have such reciprocal engagements for a period of, say, five years unless our per capita gross national product should decrease by more than about 5 per cent. Such a program would have bargaining power, would reduce uncertainty, would give additional stability to the trade structure, and would provide automatically for the possibility of adjustment if prosperity waned by a definite measurable amount. It certainly would not solve all the problems. It would create some; but it could be a step in the right direction.

It is accordingly seen that we must buy to sell. Also we must buy abroad to supply our own industrial needs in supplement to our own resources, which, as great as they are, do not cover adequately all of our wants. Further purchases abroad assist not only in the preservation of our own prosperity and employment, but likewise in promoting a free-world economy on which we can rely for security and defense, with the hope that this free-world economy will ultimately embrace the world on a peaceful basis. Our imports have increased greatly, in value and as a percentage of our gross national product, in the last few years. We have progressed considerably in reduction of our import barriers, preserving and increasing dollar availability

abroad as evidenced by the facts that 58 per cent of our imports in 1952 were duty free; our total duties collected represented only 5.1 per cent of total imports and 12.2 per cent of those dutiable. The figure is much lower than in many of the countries abroad. But on January 1, 1953 over 10 per cent of our duty rates by commodity and tariff schedule classification still exceeded 45 per cent, keeping our 1952 imports in this bracket to some $57 million or 1.3 per cent of our dutiable imports; and our duties exceeding 100 per cent were apparently so effective that 1952 imports in this bracket were less than $75,000. But a dollar balance on United States current accounts, excluding military aid, has recently been attained; foreign dollar reserves, particularly British, Dutch and German, have increased considerably, but serious restrictions on our sales abroad persist. Such increased reserves and more even balance on "nonmilitary" current account at present import and export levels evidence reconstruction and improvement abroad. Thus it appears that the problem is not insoluble. But since the balance has been obtained along with restricted dollar imports abroad, this cannot yet be considered the happy balance. What is desired is balance with liberalized trade. To effect such a balance with liberalized trade, and gain the opportunities which it involves, we must be willing to buy as well as sell, otherwise our nonmilitary exports will further decrease. To do this we need greater stability of our own policy, as well as that of foreign countries. We are not in the position where sweeping tariff reductions across the board will solve the problem. These would import depression. But neither will increased protection on a broad scale, as that will spread depression abroad with repercussions on us. But on a selective basis, taking into account the reliability or lack of it in various foreign supplies and the repercussions in our own domestic picture, we should establish the form and minimum level of protection line by line, some up, more down, and then, for an appropriate reciprocal engagement on the part of others, be willing along with others to bind ourselves not to increase the protection unless prosperity wanes by some measurable amount. Such a program with efforts to create and support a multilateral trade and payments mechanism extending over the maximum area possible would recognize that we must buy to sell, but far more importantly on

such a basis we could expect a greater comity among the nations, greater advantage to ourselves, and somewhat brighter prospects for peace.

Remarks

Chairman Morgan: Thank you, Mr. Herod. That was a most stimulating talk.

These three speeches have been very invigorating; nevertheless we might, so to speak, take this as the seventh inning.

I want to tell you a story and it is a good story that happened in this room with a table just like this and it was in the same spot. The experience was slightly terrifying.

The President of the Goodrich Rubber Company, Mr. Collyer, was here to tell us how synthetic rubber was made. He had a large glass jar at this point. He had another glass jar here. Each was partially filled with chemicals. He said, "If I put these two jars together improperly we will probably blow up the hotel and we will land in fragments in Broadway." You can imagine what the feelings were in the front row. He mixed it carefully and there was no explosion. Gradually this formless liquid began to coalesce and he made a ball and squeezed out the dampness and finally it became firm. He said, "This is just like rubber and I am going to prove it to you. I am going to bounce it on the floor and you will see that it will bounce just like rubber." But people didn't know but what it was going to explode after all. In any case, he threw it forcefully out from here, just as I am standing here, and it went high up toward the ceiling, came down and struck the head of a bald man sitting in the front row, made a neat arc off the top of his head and landed in the hands of Arthur Krock of the *New York Times*, who was sitting here. Mr. Krock was credited with the catch, Mr. Collyer was put out, and the gentleman in the front row with an assist. So much for that!

At the close of the next speech we will have a few moments left over for some questions.

The next speaker, as you see on the program, is Mr. Howard S. Kaltenborn. Mr. Kaltenborn is an expert on labor relations, having had experience and service not only within the official authority of the United States, but in private industry. Mr. Howard Kaltenborn!

Mr. Howard S. Kaltenborn: I disclaim to be an expert in this field because I long ago decided that there were few who make any valid pretenses of being expert.

LABOR POLICY AND THE STATE OF BUSINESS

BY HOWARD S. KALTENBORN
Director of Research, Industrial Relations Counselors, Inc.

I HAVE been asked to speak about "Labor Policy and the State of Business" in relation to the over-all theme of "Firming Up the Economic Arch".

That labor policy and the state of business are significantly related is evident. The state and prospects of business comprise one of the environmental factors conditioning labor policy. Equally obvious, I think, is the fact that the economic effects of any given labor policies are often incidental to the accomplishments of other objectives that are being sought. There are, in fact, not one but many labor policies designed by practical men of affairs in government, unions and managements to meet varying problems and to accomplish diverse objectives.

I will confine my remarks to these areas: an appraisal of some of the basic influences molding the labor policies of government unions and managements, a brief assessment of the probable results of those policies in 1954, and the importance of sustained effort to improve future union-management-employee relations.

FACTORS INFLUENCING LABOR POLICY

Government Policy

The political situation confronting the Administration is a precarious one. The Republican margins in both House and Senate are narrow, as we all know, and the prospects ahead are not reassuring to the Administration. In the 1954 congressional elections, the Republicans face the very real prospect of losing control of Congress. The political pattern that has repeated itself many times in the past is that, in the off-year elections, the party in power tends to lose about twenty seats in the House of Representatives. Commenting on this experience, Senator Ives has pointed out that "history puts the odds overwhelmingly against continued Republican control of Congress after the 1954 election. If the party is to hold or increase its present slender majorities in the Senate and House, we must actually reverse

the trend of history." Strong compulsions are therefore at work on the Republican high command to take steps to avoid loss of control of Congress in the 1954 elections.

Faced with these hard political realities, the Administration gives every indication that it is prepared to do these things: It is prepared to write off the CIO as a political factor while resolutely "wooing" the American Federation of Labor into becoming a Republican supporter or, at least, a neutral party in the future political campaigns, possibly by 1954 and certainly by 1956.

Last January, George Meany, president of the American Federtion of Labor, evaluated the prospects ahead in these words:

> This is going to be a big year for labor, studded with challenge, rich with promise. . . .
>
> Dwight D. Eisenhower pledged the American people during his campaign that he would be fair and just to labor. He started making good on that pledge even before entering the White House. His appointment of Martin P. Durkin as Secretary of Labor in his Cabinet inspires confidence in the new President's good faith. . . .
>
> As political realists, many of the Republican members of Congress know that it would be impossible for the party to remain long in power if it pursues a policy of cracking down on labor. Already, there is ample evidence that many in the Republican party would prefer to cooperate with labor.[1]

The failure of the attempt to woo the AFL, the present openly expressed hostility of Mr. Meany and other union officials, results not from Administration intent or indifference but rather from a combination of miscalculation and ineptness, the unfortunate death of Senator Taft, and related factors. But the same political compulsions are still present. The Administration still hopes to neutralize or gain the support of the AFL as a political factor. The difficulties have been greatly increased, but the objective remains.

Union Policy

The over-all degree of organization, although it varies greatly by industry and area, is of significance. The labor unions in this country embrace a membership which has been estimated

[1] George Meany, "The New Administration; the New Congress", *American Federationist*, January 1953, p. 16.

at roughly 14½ million persons, out of a total labor force in excess of 60 million. The experience in Great Britain, Sweden and other countries, in which unions have been long and well established and secure, suggests that the ratio of union members to all nonsupervisory and nontechnical employees may never rise over one out of two or, at most, two out of three. Nonsupervisory and nontechnical employees potentially subject to union membership in this country total approximately 46½ million. In this country, the lower of these ratios would represent a trade-union membership of nearly 24 million, and the higher ratio would yield a trade-union membership of more than 31 million, as contrasted with the 14½ million now actually organized.

Much of the trade-union membership today lacks the union consciousness, cohesiveness and solidarity which characterized the old AFL craft unions of earlier years. Present union members are often apathetic and show little interest in participating actively in union affairs. This observation is a matter of common knowledge and needs no real elaboration, although it could be easily documented. This apathy and lack of interest prevails among members of both affiliated and independent unions. Walter Reuther, in his acceptance address at the time of his election as president of the CIO, stated:

> . . .We have to recapture some of the crusading spirit we had in the earlier days, and we have to take on some of the areas of the unorganized and begin to do the kind of job I know that we are capable of doing if we pull together in the days ahead. . . .
>
> . . .We have a job, not only to organize the unorganized, but we have a job of educating and unionizing the organized. . . .
>
> . . .We have to give our members the sense of participating in a great human crusade. We have to make them conscious of the fact that the free labor movement for the first time in the history of civilization is trying consciously to give direction to the shape of history. We are trying to participate in great social changes that are taking place in the world in which we live.[2]

The foregoing and other factors contribute to a currently strong feeling of union insecurity at the leadership level. This is true of both the AFL and the CIO, but it is more pronounced

[2] "CIO Is United, Reuther Warns Union Foes", *CIO News*, December 8, 1952, p. 2.

in the latter. Although the labor movement has grown, this growth has not kept pace with the expansion of the labor force as a whole. In 1939, union membership represented 29 per cent of the total number of nonfarm employees in the United States. By 1946, this ratio had increased to 36 per cent, but since that year it has fallen to its present level of 30 per cent (14½ million out of 46½ million). Putting this another way, the total trade-union membership in the United States has remained fairly stable over the past eleven years, but during that same period the labor force has increased by approximately nine million.

But these aggregate figures are deceptive, for they conceal the fact that the AFL has grown in membership, whereas the CIO has suffered significant losses. The AFL had approximately four million members in 1939, which increased to six and one-half million in 1944, at which point it caught up with the CIO. Since 1944 the AFL has grown to a total membership of approximately nine million. The various affiliated unions pay per capita tax to the AFL on a membership of eight million and there is reason to believe that the total is closer to nine million. Even in the AFL, however, growth has been slowed appreciably, and the increase in membership represents in part merely the picking up of the members the CIO has lost.

The shrinkage in CIO membership has been considerable. Since 1944, when its ranks numbered six and one-half million, the membership has declined to the point where the CIO now claims only five million, and it is probable that the actual membership is not more than four million. Moreover, the AFL has the advantage of being a diversified trade-union federation, with 109 affiliated unions covering a wide variety of industries, whereas the CIO has only thirty affiliated unions, and half of its total membership is concentrated in two unions, the Steelworkers and the Automobile Workers.

Both the AFL and CIO, and particularly the latter, are haunted by prospects of another depression. There is a natural fear that a union membership which is organized but not unionized will tend to evaporate under circumstances in which the union cannot continue to secure for the membership tangible benefits in the form of increased wage rates, additional security provisions, and so on.

In September 1952, the president of the International Associa-

tion of Machinists wrote that the IAM could "carry on effectively even in major depressions because of the great versatility of our membership." He added, however:

> We learn from the experience of unions whose destiny is tied to the fortunes of one single industry that it is not possible to build up a backlog of strength that will hold up the standards through a major slump. A horrible example of today is the textile union which had to submit to a slash in standards because of conditions in the industry over which it had no control whatever.[3]

It is worth noting that most of the unions in the CIO and some in the AFL are the "single industry" unions, which Mr. Hayes prophesied will encounter serious difficulties in the event of any "major slump."

Fear of depression is a dominant thread running through many of the actions and statements of union officials. In November 1952, an editorial in the paper of the CIO Oilworkers International Union stated: "There is no denying that many of us are worried, for we fear that bad times or even depression may return. There's a tingling on the bottom of the feet where the holes in the shoes used to be."[4] Almost a year later, just a month ago, the same union adopted a statement on collective bargaining policy in which fear of unemployment is the dominating factor. "Barring national emergencies, we expect some decline in employment even if business conditions remain good. There is the further possibility that a sharp recession may occur. If this does happen, there undoubtedly will be substantial layoffs in the oil, chemical, and allied industries and there certainly will be widespread unemployment in all industries. . . ."[5] The same fears are readily apparent in relation to other unions.

So, by way of summary, we see that among the basic influences molding the labor policies of the trade-union movement are the following:

1. It is incompletely organized and much of its present membership is apathetic and described as being not "union-minded", or as "organized" but not "unionized".

[3] A. J. Hayes, "Pre-Convention Thoughts", *Machinists Monthly Journal*, September 1952, p. 323.

[4] "Prosperity or Depression Ahead?", *International Oil Worker*, November 17, 1952, p. 12.

[5] *International Oil Worker*, October 12, 1953.

2. It is in the process of coming into new hands, and this is always a critical moment. Philip Murray is dead, William Green is dead, Sidney Hillman is dead, William Hutcheson is dead, Harvey Brown is retired, Dan Tobin is retired, and John L. Lewis is of very advanced age.

3. Its leaders are fearful of the future and uncertain as to how to prepare for it.

4. The strategy of its leaders has been rooted for some time in the conviction that its major hope for surviving any substantial depression, with its strength in membership substantially intact, lies in political help from Washington. The results of the last election and subsequent events culminating in the resignation of Martin Durkin have produced both fears and uncertainty as to the degree and kind of help to be expected from Washington.

Management Policy

There is evidence of a changing philosophy on the part of industrial top management as to the basic and fundamental nature of its responsibilities and job. Many who are a part of or close to the inner workings of large American corporations testify to this change. It is apparent in the speeches and writings of leading business men, though these public statements are relatively few, since business men as a group have not been very articulate.

Up to twenty, thirty, or so years ago, there was little question that top managements, for the most part, viewed the stockholders' interest as being the dominant interest to be served by top management. This is illustrated by the following statement written some twelve years ago:

> The point of view of the board of directors must by the nature of this relationship be identical with that of the stockholders. At all meetings of the board, this viewpoint should outweigh any other consideration. In fact, the fundamental concept of the first zone or level of management is management for the benefit of those who own the business.[6]

There are, of course, many companies in which this view still

[6] Paul E. Holden, *et al.*, *Top-Management Organization and Control* (Stanford, 1941), p. 17.

prevails. Nevertheless, a significant change in that philosophy has taken place in many companies.

Ralph Damon, president of Trans-World Airlines, writing in December 1952, stated that, "Although management has responsibilities to several groups, its primary responsibility is to act as a trustee for the owners."[7] This philosophy represents some departure from that expressed above.

Still another top business leader, a chief executive of a very large oil company, has stated his belief that the stockholder view used to dominate the thinking of top management, that management must still view things primarily from the standpoint of the stockholders, but that there nevertheless has been a vast change in top management's concept of its responsibilities. He indicated that "it is now just good business for the *stockholders* to protect the interests of the employees, the customers, the public, and the State." He declared that the top managements must try to persuade the stockholders that

> . . .it is in their long-range interests for the company to use their money for maintaining other important things besides paying out dividends. We have to convince the stockholders that they don't have a thing in this company but [000] employees . . . . All these things represent quite expensive drains, we might say, on the stockholder and do sometimes cause the stockholder to feel critical, at least until we have discussed these long-range aspects with him.

This executive summarized his thinking on this point as follows:

> To sum up things, we have these several conflicting, or apparently conflicting interests of the stockholder, the customer, the employees, and the State. Out of all that, we resolve a pattern which we believe is ultimately in the greatest interests of our stockholders and which, I think, pretty well represents the greatest interest of all the other elements that go to make up the pattern.[8]

This statement typifies an intermediate stage of the transition in management philosophy that has been taking place. Many business leaders today have carried their philosophy as to top management's responsibilities one step further and now view the stockholders as being only one of several influences surrounding

[7] Ralph S. Damon, "Responsibilities of Effective Leaders", *Dun's Review*, December 1952, p. 21.

[8] An unpublished address, June 4, 1952.

the company which in some way must be harmonized or reconciled in the interests of the company as a whole. This philosophy may be illustrated by the remarks of a number of business leaders cited below, and the list could easily be expanded.

Frank W. Abrams, Chairman of the Board of the Standard Oil Company (New Jersey), has said:

> Of course, a business must be profitable to remain healthy, but you will find that a maximum immediate profit is no longer considered to be the sole guide of private enterprise. You will find management earnestly dedicated to maintaining a workable and acceptable balance among its shareholders, its employees, its customers and the public at large.[9]

Henry A. White, president of the Dole Hawaiian Pineapple Company, Ltd., has stated that the job of management is "striking the best possible balance among the various pressures brought to bear upon it. It is a job which by its very nature cannot provide complete satisfaction to the ultimate requirements of any one group—be they stockholders, employees, or consumers."[10]

Gwilym A. Price, president of Westinghouse Electric Corporation, has expressed his views in these words: ". . . it is the responsibility of management to maintain a fair balance between employees, stockholders and customers . . .", and he adds, "What does management do under these circumstances, where three separate groups are naturally pulling for their own advantage? It sets up what it believes to be a fair policy for each one, and enforces it firmly."[11]

Sidney J. Weinberg of Goldman, Sachs and Company, and a director in a number of very large influential companies, has said this: "In carrying out his functions, the director must take the long view in decisions and bear in mind the public interest.

[9] Frank W. Abrams, "The Individual in a Group Society", *The Lamp*, June 1952, p. 5.

[10] Henry A. White, "Some Responsibilities of Corporate Management", p. 1—excerpts from a talk; distributed as a pamphlet by the Dole Hawaiian Pineapple Company, Ltd., Honolulu, Hawaii.

[11] Gwilym A. Price, "Westinghouse and Unions; the Case for Co-operation", October 10, 1952, pp. 6, 9. Address at the IUE-CIO Fourth Annual Convention; distributed as a pamphlet by the Westinghouse Electric Corporation, Gateway Center, 401 Liberty Avenue, Pittsburgh, Pennsylvania.

He must have a social sense and must be continually aware of the human problems involved in decisions of the board."[12] As all of us know, instances could arise in which the survival of a company would not serve the best interests of the stockholders. One writer thus summarizes management responsibility in this area: "It is now generally agreed that men can exist either as directors or executives in large companies only in so far as their first concern is for the company's existence."[13]

Jackson Martindell, in a recent book, goes even one step further. He wrote that the true status of the stockholder "is that of residuary legatee, rather than of owner, no matter what the law may pretend." He also indicates a belief that the stockholders' interest is subordinate to "all other obligations of the corporation . . . social as well as legal."[14] This opinion, of course, makes the stockholder the lowest man on the totem pole. Most managements would not be willing to carry their philosophy to this point.

Thus, over the years, the philosophy of top management—top management's concept of its own job—has been in the process of transition. It has been changing from a philosophy that the stockholders' viewpoint "should outweigh any other consideration" to the philosophy that top management must maintain "a workable and acceptable balance among its shareholders, its employees, its customers, and the public at large." It is obvious that top management is beginning to see its rôle as one of protecting the survival of the company as an institution. In so doing, top management sees itself surrounded by pressure influences, the stockholders, unions, and many others whose interests run sometimes in parallel and sometimes in opposite directions, with top management having to set up "what it believes to be a fair policy for each one" and then enforcing it "firmly".

Not only has the philosophy of top management been in the process of change, but management likewise is concerned over the possibilities of recession. This concern is readily apparent and has been reflected in many statements. In recent months,

[12] Sidney J. Weinberg, "A Corporation Director Looks at His Job", *Harvard Business Review*, September 1949, p. 592.

[13] Herrymon Maurer, "Boards of Directors", *Fortune*, May 1950, p. 132.

[14] Jackson Martindell, *Scientific Appraisal of Management* (New York, 1950), p. 138.

some prominent business men have taken note of this, and have urged that we stop "talking ourselves into a recession."

Whenever a decline in business seems imminent, or probable, or in prospect, caution will dictate to management a policy of "tightening the belt"—of protecting the survival and possibilities for progress of the business while being "fair" to the parties involved. Cost increases will be more vigorously resisted, and the overriding consideration against which demands will be measured will be survival of the business as a going institution.

PROSPECTS FOR THE NEAR FUTURE

Though 1954 will bring changes in government labor policy, the economic impact of these changes will be of little significance. Primary attention will be focused on the Taft-Hartley Act. Important though the provisions of the Taft-Hartley Act are, the economic impact of the probable changes will be slight. Although an increase in the minimum wage under the Fair Labor Standards Act will be brought up for Congressional consideration, any change in 1954 seems unlikely. It is probable, however, that there will be changes in the Social Security Act in terms of increased benefits or changes in the tax structure called for in the present law. Again, however, the economic impact on the total economy of the benefit and tax structure probably will not be significantly different in 1954 than in 1953.

The probable changes in government labor policy in 1954 will reflect primarily political considerations, not a desire to use government labor policy in an attempt dramatically to influence economic trends. Moreover, the Administration is committed to a policy of less government intervention in labor-management relations, more reliance on the parties themselves. But President Eisenhower also made it clear in the election campaign that nonintervention by government would obtain only if the business system provides adequate employment opportunities. "Never again shall we allow a depression in the United States", he said, and supported the statement in these words:

> So I pledge you this. If the finest brains, the finest hearts, that we can mobilize in Washington can foresee the signs of any recession and depression that would put honest, hard-working men and women out of work, the full power of private industry, of municipal govern-

ment, of state government, of the federal government, will be mobilized to see that that does not happen. I cannot pledge you more than that.[15]

There is more than symbolic significance in the fact that the phrase "private industry" appears before that of "state government" or "federal government". It is in keeping with the President's expressed philosophy of less government intervention. You will recall his references, in his speech at the 1952 AFL convention and elsewhere, to "the heavy hand of Government intervention" and the "miserable failures" resulting "when Government has abandoned the rôle of impartial referee and become a participant in the contest."

Labor policies of the federal government will have but little significant economic impact in 1954, although government actions in other areas will exert great influence on the trend of the economy. Of greater *economic* significance than government labor policies in 1954 will be the results produced by the meshing of the labor policies of labor and management in their private capacities.

Despite the known hazards of forecasting in the volatile area of labor-management relations, I venture to suggest the following probabilities, based on (1) an analysis of the factors influencing labor policy for managements and unions, and (2) the assumption, which I believe to be sound, that 1954 will not bring any severe or prolonged recession.

The year 1955, not 1954, will be the critical year in labor-management relations. Despite the many important contracts open for negotiation in 1954—steel, rubber, electrical, coal, oil, and others—the prospects are for a year of relative peace on the industrial front. On the assumption that the influences toward recession will be moderate in 1954, then both managements and unions will prefer settlements for moderate increases to strikes. The increases will probably be lower than in 1953 because managements will more strenuously resist increases in cost and unions will be in a somewhat less favorable position to exert bargaining pressures.

The contracts in the automobile industry carry over until 1955, but the 5 cents per hour increase in 1954 resulting from the

[15] Address at the Hotel Theresa in New York, October 25, 1952, *New York Herald Tribune*, October 26, 1952.

"annual improvement" factor will influence the course of negotiations in other industries.

Greater union emphasis will be placed on the guaranteed annual wage and other "fringe" items. Long-term contracts with wages tied to some automatic formula will decrease in number and importance, because of both uncertain economic prospects and the controversy over the "living document" approach.

Union political action will be intensified, and energies will be partially diverted from the economic to the political front. Moreover, with the congressional elections then approaching, neither unions nor managements will wish to have the elections held against a background of public unrest occasioned by widespread strikes.

Now consider the prospects for 1955. The elections will no longer provide a barrier impeding strikes. Unions will relax their political efforts temporarily and again concentrate more on the economic front. The automobile contracts will exert some influence on other negotiations in 1954, but, unless 1954 negotiations take an unexpected turn, no similar conditioning influence will be present in 1955. Unions in 1955, barring distinctly unfavorable economic prospects, will be prepared both for major negotiation efforts and for "breaking new ground" in terms of the guaranteed annual wage and other issues.

THE TRAGEDY OF FAILURE

Any realistic appraisal of labor policy and the state of business should take into account the possibilities for progress and the tragedy of failure. This can be dramatically highlighted by consideration of the unhappy developments that would flow from a severe recession. Where a recession is both mild and short, and *is expected to be such,* the effect on industrial relations should be slight, and other considerations would be more compelling. But consider briefly some of the probabilities if a recession were severe.

It is difficult, if not impossible, to have good industrial relations and good employee morale in an unprofitable company with uncertain or bad prospects for the future. In this situation, forces that are adverse to good industrial relations begin to influence managements, employees and unions. Managements confronted with real cost pressures see their industrial

relations programs and activities as costing money and yielding benefits that are intangible or at least hard to measure and they are tempted to cut the industrial relations program. Employees, faced with uncertain or dismal prospects, lose morale, evidence insecurity, and develop attitudes of "Let's get it now." Unions fear recessions, for they know that many union members are "organized" but not "unionized", are not "union-minded", as such, but are in the union for the benefits they can get. The unions, confronting a declining market and inability to gain added benefits, see their memberships dropping and their existence threatened. Faced with this threat to survival, unions time after time in the past one hundred years have shifted their emphasis from the economic to the political front and tried to divert their membership accordingly. The dangers in this are obvious. In the past, union efforts to divert their membership's interest primarily to politics have always failed. Particularly up to 1900, the record is littered with the dead bodies of unions that tried this and failed. Unless the situation were desperate, the probabilities are strong that union members again would not follow their leaders politically. This leaves an insecure union, its existence threatened, tending to become less responsible. The labor movement would not submit to the threat of extinction peacefully.

A severe depression would pose a basic and perhaps insolvable problem. This then would be the basic challenge: In the face of a serious decline in business, how could the interests of society in the survival of business and our business system be protected while still guarding the interests and security needs of employees, and of unions threatened with extinction and tending to an increasing degree toward political action?

That 1954 will not pose this problem in an extreme form is fortunate. Our society in its present form could not survive another severe and prolonged depression. Labor policy can contribute to "Firming Up the Economic Arch" only as it is based on a sound foundation permitting progress toward more constructive and firmly based union-management-employee relations. Significant areas exist in which there are possibilities for real progress. The best efforts of men in all walks of life should be brought to bear upon the problems and possibilities.

DISCUSSION: FIRMING UP THE ECONOMIC ARCH

CHAIRMAN MORGAN: Thank you, Mr. Kaltenborn, for a fine, well-delivered talk.

Are there any questions?

QUESTION: I would like to ask Mr. Herod, if we have to buy to sell, what products, aside from the raw materials that we may be deficient in, can America buy in substantial quantities without dislocating parallels in this country?

MR. HEROD: I think, of course, the biggest opportunity for the purchase in scale which would affect the balance of payments and those things is increased purchase of raw materials and semifinished goods which now constitute something like 60–66 per cent of our total imports, since we are not self-sufficient. We may project into the future as, for example, the Paley Commission did last year, when they projected a doubling of the gross national product within the next generation, which would mean increasing our dependence upon external material supplies by a considerable multiplying of our present imports. That, I think, is the major one.

Secondly, there are many lines where tastes differ and where a parallel article can be sold to those who have a taste for it without dislocation of the American market. My own feeling is—and I don't think you could get ten industrial or commercial people to agree on this—that, for example, there are a few people who want the style of a European automobile either for the social distinction of a Rolls Royce, or the appeal of the little Renault. But the opportunity to sell in this market with an acceptability in the market on scale is very, very slight, I judge, because those experts in that particular field or industry are of the opinion that the 10 per cent tariff which they now have could easily be changed, according to Mr. Henry Ford and according to the Detroit Chamber of Commerce.

There are other items, particularly those in the jewelry line, in the cosmetic field, in the field of stylized clothing, requiring a good deal of labor or what might be called labor intensity, which are made for personal styles and tastes; but our economics is based upon mass production. In other words, we can get a low-priced pair of shoes, or a low-priced suit, generally speaking—as high as they may seem to most of us, they would be a lot higher otherwise—by setting up our tools and running through millions of pairs of those shoes, whereas certain people want—and that percentage is very small—for example, their own style or their own fit. And in the things in which style is involved, I believe that there is an opportunity and I do not believe that that would be any considerable dislocation to the American market at all.

I think in the major fields, however, in accordance with our economic development, that if we are going to increase our industrial output, we

are going to have to buy much more. We used to export oil. We are now importing about a million barrels a day. We used to export copper. Roughly a third of our copper consumption is now imported. We used to export iron and steel products very extensively. Although we still export them, we are now getting iron ore from Venezuela. We are now developing new Laborador fields and others. So if that happens to be the biggest place of advantage to the economy without dislocation at all—there may be parallel things outside the style line—I think we can increase it.

CHAIRMAN MORGAN: Are there any more questions? If not, thank you for your kind attention and I especially thank the gentlemen who have spoken to us with so much frankness, skill and information.

PART III

THE AMERICAN ECONOMY, KEYSTONE OF WORLD PROSPERITY

INTRODUCTION

LEWIS W. DOUGLAS, *Presiding*

Former Ambassador to Great Britain
President, Academy of Political Science

MEMBERS of the Academy and its Guests: This evening marks the terminating occasion of this meeting. The day has been devoted to a discussion of "The American Economy, Keystone of World Prosperity". A variety of things have been discussed learnedly and, I hope, to the advantage of everyone, including those who spoke.

The federal budget was very carefully and meticulously dissected. Probably everyone has forgotten the days when the budget was in balance.

Taxes were diagnosed in their various aspects and influences upon society, and what is known as economic stabilization was the subject of a considerable discussion.

The business outlook for the pessimists and the optimists was described, and I am not certain whether anyone really placed any confidence in the prophecies that were made.

The public debt and its management received very careful treatment. The only thing that need be said tonight is that it is far too large. Foreign trade, which everyone concedes is necessary but which no one is prepared to pay for, was also the subject of considerable controversy, and I presume will remain the subject of considerable controversy for a protracted period. Labor policy also was dealt with by one of our distinguished speakers. It will be enough to say tonight that there will probably be labor for many generations.

Now I should like to thank all of those who spoke so knowingly and so knowledgeably about all of these subjects. I should like to thank them (and spank them) in the name of the Academy. After all, no one can open one's mouth without being spanked by somebody, although it isn't on the mouth that one is spanked. This isn't an anatomical discussion, but I should like to thank them all.

Tonight, in part at least, we will deviate from the subject which has been discussed today. It was "The American Economy, Keystone of World Prosperity". There is a part of the arch of prosperity which in one sense is American, and which in another sense is not American.

It is rather amusing to look back over history from our point of vantage and to remind ourselves of some of the rather turbulent periods in American-Canadian relations. During the Civil War, despite the friendship of Canada for the antislave movement, a certain number of ingenious Confederate agents managed to establish a base north of the line. From that base they engaged in several raids against Vermont, the sole remaining state on which one can rely. This caused a considerable amount of consternation among certain of the contingents who were fighting the cause of the Union. Indeed, so great was the consternation that the Secretary of State undertook to warn Her Majesty's Government, as it was then, that the Rush-Bagot agreement of disarmament would be terminated. Fortunately, the Confederates in Canada were brought to order and it was never terminated; but the Reciprocal Trade Agreement Act of 1848 was terminated, and Congress went so far as to pass legislation at the time which contemplated the admission of Canada to the Union. Feeling ran high.

I am not being uncomplimentary to Canada when I say I think it is very fortunate that she wasn't admitted to the Union—or, rather, did not apply for admission. I think it is fortunate for her because she would now have to carry burdens which otherwise she wouldn't have to carry. But, at any rate, the feeling ran so very high that there was a marching song popular among the troops of the North which went something like this—it was sung to the tune of Yankee Doodle, about this extraordinary fellow:

Secession first he would put down
Wholly and forever
And afterwards from Britain's Crown
He Canada would sever.

And there was an American orator in the Senate—obviously he was a flamboyant orator—who went so far as to say that the boundaries of his country God Almighty had established reaching to the aurora borealis on the north; about the boundary in the south he was discreetly silent.

Well, this went on for quite a period. There was even a battle fought by the Hibernian Society. It was the battle, as I recall it, of Limestone Ridge, but the Irish were repulsed by the Scots north of the border; and in 1911 much the same issue again reappeared. It reappeared over the issue of reciprocity, and the Speaker of the House then asserted, with a considerable amount of arrogance and flamboyance, that he favored the Act of Reciprocity. "I am for it," said he, "because I hope to see the day when the American flag will float over every square foot of the British North American possessions clear to the North Pole!"

There is a strange parallel between that which was said at the close of the Civil War and that which was said prior to World War I; and presently Taft himself had something to say. Rudyard Kipling asserted he did not understand how nine million people could enter into such arrangements, speaking of reciprocity, with ninety million strangers and at the same time preserve their national integrity.

These are things that we resurrect from the past and they now strike us with a considerable amount of humor. These strains of friendship have long since disappeared, and I suppose it is fair to say that the spectacle of two separate sovereigns, Canada and the United States, living side by side in complete harmony, marching together down the road of international politics, bound, united by the ties of propinquity, the bonds of common interest and the links that have been forged on the anvil of identical dedication to principle, is a spectacle which establishes an example for the whole world. And if we look upon Canada now with envious eyes—and we do—I submit that it is a compliment to Canada, and a compliment to our-

selves. Sir Rayford Laurie put it forcibly when he said, "We Canadians should not look upon the Americans, when they cast their envious eyes northward, as something which is offensive. The Americans know something good when they see it."

Not least of the good things about Canada today is its government. I venture the assertion that no country in the civilized community has been so well governed over the course of the last fifteen or more years as Canada. A group of intelligent men, skilled in the arts of government, knowledgeable, dexterous, resilient, has met all the tests of the last fifteen years. There is probably no similar period in which more tests have been concentrated with such an amount of success, and, what is even rarer, wisdom, in modern history. Not the least among those who have governed Canada carefully and so well—a Canada that has played its rôle in international politics—is the guest of the Academy tonight.

He has had a very distinguished career. He is a graduate of McGill University. He is a King's Councillor. He is a member of the Privy Council. He was elected to the House of Parliament in 1940. He has been Minister of Defense, and therefore he is capable of speaking the same language that Mr. Wilson speaks. It is the same language in many respects. He has been Minister of Finance since 1946, and it is in this area of finance that Canada presents to the whole world such an example of skillful, artful and wise management.

It is a pleasure for me personally to introduce a friend, and I know it will be a pleasure for you to receive Mr. Abbott, the Minister of Finance of the Commonwealth of Canada.

Remarks

Hon. Douglas Abbott: Mr. President, Members of the Academy, Distinguished Guests, Ladies and Gentlemen: I want to thank you first, Mr. President, for the delightful way in which you have presented me to this distinguished gathering, and for the things which you said about Canada. I suppose that in part your capacity to do this is derived from your Canadian ancestors. At any rate, I can assure you that what you have said both about me and about my country is most warmly appreciated.

CANADA'S CONTRIBUTION TO WORLD PROSPERITY

THE HONORABLE DOUGLAS C. ABBOTT

Minister of Finance of Canada

THE general theme of your meeting today has been "The American Economy, Keystone of World Prosperity", and your President and my very good friend, Lewis Douglas, asked me to speak on whatever phase of this subject I cared to select. I do not think you or he will be surprised if I do not speak directly on your topic. You do not need my praise, and I am a sufficiently experienced politician to know that audiences in one country do not welcome or appreciate lectures from outsiders on how they should manage their affairs. I propose, therefore, to speak on the parallel theme of Canada's contribution to world prosperity. If there are any morals to be drawn, I will leave them to you.

Canada's part in the maintenance and development of world stability and prosperity presents a number of similarities to the rôle of the United States. I am no expert in the technical language of architecture, but, if your country is the keystone of world prosperity, perhaps mine could be described as one of its flying buttresses.

Like you, we are a North American country, and our past history and, therefore, some of our current habits of thought reflect the expansive environment and the relative remoteness from the Old World in which our two nations have grown up. With you we share in large measure a common economic culture. We have a common technology. We produce and we organize and operate our industries in much the same way. We both believe in freedom and in free competition—at least within our own borders. Our ideas on what is a sensible relationship between government and business are not markedly divergent. We have both experienced a dynamic past; and, like you, we take a dynamic and optimistic view of the future. Canadians, as individuals, do not like being mistaken for Americans when they travel abroad—as we sometimes are—but we have to admit that Europeans cannot be blamed too severely for the mistake.

But, while we have these similarities, the differences and contrasts between our position and yours are very substantial.

First, and most obvious, are the great differences in size and wealth. While we are growing rapidly—I believe our rate of growth is a bit more rapid than yours—you still have more than ten times our population, and your productive capacity and accumulated wealth are fifteen to twenty times greater than ours. The sheer weight of the world impact of your policies and of vicissitudes in your affairs is incomparably greater than ours.

While we have great resources of farm, forest, mine and sea, they are much less varied than yours. Occupying as we do the northern half of this continent, the variety of our resources is limited by the facts of climate and geography. We produce, as you know, great quantities of pulp and paper, copper, lead, zinc, asbestos, gold and uranium, and now, or in the near future, our output of oil, natural gas and iron ore will be a significant contribution to world supplies. We produce the highest qualities of beef, bacon and cheese, and our hard wheat is the finest in the world. But we cannot grow cotton, oranges or rice. Our growing seasons are relatively short, and in many other respects the variety of our output has been circumscribed by nature. In very few important things do we have a balanced self-sufficiency. For most important commodities we have either a heavy export surplus or a large import requirement.

We are therefore much more directly dependent upon international trade than you are. I believe, and I know you realize, that your strength and well-being are also heavily dependent upon an expanding and well-balanced world trade. To us in Canada our dependence on trade is self-evident—it requires no argument or explanation; but I have the impression that to many Americans their similar dependence is not so obvious, for it is a dependence at one remove—it has to be explained and is not always easily or quickly understood.

Another difference between us is the historical background of our ties with Europe, which affects to some extent our current thinking on international economic relations. Like you, we are a free and independent nation, but, unlike you, our political separation from Europe came gradually and by an evolutionary process. It came about without bloodshed and without recrimination. It left no ancient grudges to be perpetuated in

our school books. It is difficult to assess the weight of this factor on the course of public opinion, but I think the ordinary rank and file of Canadian people have rather fewer mental reservations and road-blocks when they think about international relations.

The only other point of difference I shall mention arises out of the question of foreign investments. Both our countries in their formative stages were developed largely by foreign capital. For you, that happened quite a long time ago. With us it is quite recent; indeed, in some fields it is still going on. We realize the value of foreign investment to the recipient, and we know that it is not just the inflow of money that is valuable, but equally important are the technical and managerial skills that normally accompany it. But we are also aware of the economic and political problems which heavy capital inflows bring with them. We have no doubt where the balance of advantage lies, but I think we can understand, though we do not share, some of the suspicions and doubts which are entertained by quite a few of the newer developing countries about the political dangers of private or even intergovernmental foreign investment.

This may seem rather a long preamble to the substance of my address, but because of our many similarities it sometimes happens that Americans rather take us for granted and tend to overlook the differences, which are very real, which are important elements in the Canadian character and outlook, and which make us see things a little differently or react a little differently to the trend of events.

Canada, it seems to me, is an essential partner in any program for world stability and prosperity. Our partnership with the United States is implicit in the North American economic facts of life, and has been made explicit in such instruments as the Permanent Joint Board on Defense set up in 1940, and the Agreement on Principles for Economic Cooperation signed in Washington in October 1950. We are also in partnership with the United Kingdom, a partnership based upon history and tradition, loyalty to a common crown, and the ties of long-established trading relationships. Our partnership with the United Kingdom and the United States is further broadened and linked into our partnership with Western Europe through the

North Atlantic Treaty Organization. We have, in addition, our strong bonds of Commonwealth membership with such countries as Australia and New Zealand, and through the Colombo Plan and other contacts we are developing growing ties of friendship and understanding with Southeast Asia.

In terms of our geography and our resources, we are essential both to the strategy of defense and to the strategy of peace. Yet we realize that we are in no position to go it alone. We need the United States, the United Kingdom, Western Europe and all our other friends as much as you and they need us. The free nations of the world are all members one of another. Isolationism has never been a significant force in Canada—it flies in the face of every fact of our geography, history and economics.

You may ask: What does Canada bring to these partnerships? What can it contribute to the community of free nations? It can bring both things and ideas.

First, and most important, in any listing of resources are our peopl. The population of Canada is growing rapidly, both by natural increase and by the largest flow of immigrants that we have experienced in the past forty years. There are now 15,000,000 of us. Nearly one third trace their origins back to France and retain French as their mother tongue. About one half trace their ancestry back to the British Isles—most of them directly, though quite a number have forefathers who lived for a generation or more in the American colonies or later in the United States. Nearly one fifth of our people, themselves or through their parentage, represent the races and cultures of every country of Europe. Although we are so diverse in our racial and cultural make-up, there has never been a time when we were all so essentially and unitedly Canadian. This is not because we are fusing all this diversity into a new uniformity, but because we have accepted the necessity and the desirability of consciously retaining both our main languages and cultures, and building our society on a friendly partnership of both.

We are a hard-working and a highly skilled people, and during the past fifteen or twenty years we have made great new strides in developing scientific research and managerial skills. We have retained a considerable measure of the old-fashioned virtues of prudence and thrift. Some of my American acquaintances say we are somewhat lacking in imagination and the spirit

of adventure. We tend, I think, to be emotionally more stable or less volatile than some of our friends. Our brighter critics at home tell us we are too respectably dull. But experience has shown us to be reliable friends, and in the testing times of the nations we have proved ourselves capable of powerful and sustained effort.

On the material side, I do not propose to give you any detailed catalogue of our resources. We are one of the greatest food producers in the world. We are one of the richest and most varied sources of minerals—from copper to uranium, from nickel to titanium, and from gold to iron ore. Our abundance of low-cost hydroelectric power is the basis of highly efficient aluminum and chemical industries. On the existence of huge reserves of natural gas we are building up a whole new petro-chemical industry. Our forests provide most of you with your daily newspaper, and they supply the lumber for homes and industry both on this continent and overseas. We have developed a considerable variety in our manufacturing industries, and a growing number of these have reached a point in costs and efficiency where they can compete in world markets.

Canada is an efficient large-scale producer of many of the most important materials and products essential both for defense and for the peaceful development of rising standards of living all over the world.

These are some of the things that we can contribute to the partnership of free nations for the promotion of international peace and prosperity. We can also, I believe, contribute ideas. Not all our ideas are highly original—some of them may be considered a bit old-fashioned. But we hold them rather firmly—perhaps even rather doggedly.

First, I should say that we are realists. Because of our dual culture and because of the sharp regionalism of our economics and politics, Canadians are familiar with the world of practical compromise. We are accustomed to look for good practical solutions rather than theoretically ideal solutions. We prefer a practical compromise that works, to a logical solution that does not. We have learned that the only agreements that are likely to stand up to the pressure of events are those that are based upon continuing mutual advantage. Most people and most nations act most of the time in pursuit of their own enlightened

self-interest. Emotions and idealism are, of course, very important, but we Canadians are skeptical of plans or policies based primarily upon them.

You remember the Duchess in Alice in Wonderland. I hope Alice never goes out of fashion. She is the repository of so much practical wisdom as well as concealed higher mathematics. You remember that the Duchess remarked that it was love that made the world go round, and Alice's reply that she thought it was done by everybody minding their own business. Canadians, I think, are inclined to agree with Alice.

In both our domestic and our international relations we are always looking for practical solutions, a step at a time, based on a fair balance of give and take. In negotiations, we pursue our own long-run self-interest and we expect other countries to do the same. We expect to have to compromise on less essential points and we expect others to do this also. Only agreements based on this sort of realistic negotiation are likely to be reliable foundations for further advance.

There are plenty of problems in the world today that call for this kind of negotiation. I shall not venture into the high political field, but I should say something about international economic problems because that is a field in which I have, of necessity, taken some measure of responsibility.

We in Canada have been impressed by the degree of progress made in the political and military spheres under the auspices of the North Atlantic Treaty Organization. Perhaps NATO has not done as much or gone as far as some people hoped or expected three years ago. But real progress has been made; we have come quite a long way. Frankly, however, we in Canada are genuinely concerned about the thin and rather brittle economic base upon which this political and military coöperation has been built. We are convinced that the political and military security of the free world must have a more solid economic base, for I am enough of an economic determinist to believe that if the economic base cracks again, it will be extremely difficult to maintain the measure of political understanding and military coöperation which now exists.

We are therefore strong advocates of moving as rapidly as possible to the highest practical levels of free and fair trade on a multilateral basis. We know all the difficulties and complexities

of moving in this direction, and we realize the inevitability of a step-by-step process. We would like to see some bolder steps taken, and we would like to see a smaller time interval between steps. Over the past few years, I have attended quite a number of international meetings where these matters have been discussed. I attended the Commonwealth meetings in London a year ago, and I expect to attend another meeting of the Commonwealth Finance Ministers in Australia early in January. We in Canada, and our colleagues in the rest of the Commonwealth, have firmly accepted the objective of multilateral trade and investment and the progressive withdrawal of trade and currency restrictions as rapidly as possible. Canada, through good fortune (and, we like to think, a certain amount of good management), has in all practical respects reached this position. Our colleagues of the sterling area have made a good deal of progress, but are still some distance from the goal. The sterling area, as you know, is a great trading area. It is, I believe, prepared to take firm and substantial steps toward our common goals of multilateralism, nondiscrimination and convertibility if it can feel assured that it will be met halfway. We have been encouraged by the many indications that public opinion in the United States is moving along converging lines. We are convinced that every country, Canada, the United Kingdom, the United States and the whole free world, will benefit tremendously from moves in these directions. If we can thus deepen and strengthen the economic base upon which our political coöperation necessarily rests, we shall in fact have greatly improved our whole defensive position.

Prosperity among members of the free world is essentially indivisible. We all recognize the key position of the United States. We expect you, as we expect other countries, to pursue policies that accord with your own enlightened self-interest, in the future as in the past. If you really do this, we shall not be disappointed.

Another idea that we have is that political and economic freedoms are good things, but that they find different expression in different peoples at different times. The institutions of our own country, and those of our Commonwealth of Nations, are based upon the idea of the peaceful and friendly coexistence of differing political systems and sharply different cultures. Canadians have

no urge to remake mankind into their own image. We have found that we can work constructively with those who do not enjoy the advantages of our parliamentary system, with those whose ideas of the government's proper rôle in economic affairs are quite different from ours, or with those who have scales of social and personal values which we would not care to adopt for ourselves.

Freedom and progress in economic affairs are not things which can be conferred or imposed upon people from without. Fundamentally they must grow and develop from within, but, as you and we and other technically more-advanced countries have shown, there are many ways in which we can help the technically less-advanced countries to accelerate their development; and both your country and mine, each in proportion to its resources, have done a great deal to help restore the ravages of war and share the costs of collective defense.

Like you, we regard the loans and grants which we have made primarily as an investment in our own future as well as being investments in the future of the receiving countries. This kind of investment on the scale on which we and you have been operating for the past seven or eight years is not the sort of thing that can go on indefinitely. But in so far as Canada is concerned, we are reasonably well satisfied with the political and economic dividends which they have so far assured. It has been our experience that the best results have come from those operations where a large part of the initiative and finance has come from within the receiving country.

These are some examples of how we have tried to be constructive partners in international economic affairs, and I have tried to indicate the way and the spirit in which we approach these matters.

I should like to conclude by referring to one of the greatest and certainly one of the shortest after-dinner speeches ever made. It was nearly 150 years ago. After six years of failure and disappointment, the great news of the victory of the battle of Trafalgar had reached London. It was also the day of the Lord Mayor's annual banquet at which the Prime Minister is the traditional guest of honor. The cheering crowds had unhorsed Pitt's carriage in the streets and drawn it in triumph to the Guildhall steps. At the dinner Pitt was toasted as the savior of Europe.

His speech in reply can be quoted verbatim. "I thank you", he said, "for the honor you have done me. But Europe is not to be saved by any single man. England has saved herself by her exertions, and will, I trust, save Europe by her example."

I suggest that we and you may well adapt this sentiment to our present circumstances.

Our first duty is to ourselves and our respective countries. We must each by our own exertions keep ourselves strong and free and expanding in both wealth and well-being. You and we also know that we cannot be strong and free in isolation, or even in isolated partnership. We in North America need the friendship and the freest possible two-way exchange of goods, of services and of ideas with Europe and with the rest of the world; and we must exert ourselves to make this possible.

We can also contribute to world stability and prosperity by our examples. We can each in our own country set examples of toleration, of dynamic expansion, and of rising standards of living, all achieved in a climate of political and economic freedom. In our relations with each other we can set an example of good sense in settling difficulties and disputes, good sense in speaking frankly but without acrimony, good sense in trade, and good sense in respecting each other's differences in ideas and in the way of doing things.

The world urgently needs both our exertions and our example.

Remarks by the Chairman

President Douglas: We are very grateful, indeed, to you for striking from your busy life time to come to the Academy to address us.

You referred to the short growing season in Canada. As an American I can say that we are grateful that your growing season is so short. We don't know what would become of us if your growing season were longer.

You have made references to the need for the expansion of international commerce and of our partnership in this important affair. We on this side of the line have a very great stake in convertible currencies. There is no interference with the flow of commerce as insurmountable and as unconquerable as a nonconvertible currency, for the exchange restrictions imposed by the governments on currencies that are not easily convertible defy the ingenuity of the most skillful exchange arbitrager wherever he may be in the world. If we are to have a larger volume of foreign trade, then it is imperative that wisely, prudently, we establish the environment in which we may revert to that type of international monetary system with which the civilized world was acquainted for almost a century. This task will not be easy.

The memory of man is short. Men's minds are often very confused. We are forgetting that during the last war, indeed we forget even more that during World War I, as much as the men in the uniform contributed to victory, there was that solid, massive productive capacity of this country that made it possible for them to assault the enemy and to take his lines. It was the capacity of American industry to produce planes and guns and tanks and all of the modern lethal weapons that men used to kill each other and to destroy the defenses of our opponents. It was the final basic foundation upon which our forces could advance. This is something that Americans soon forget, but should not.

When the present Administration in this country came into power, there was called to the position of Secretary of Defense a person who had had as great an experience in the production of goods for peace and goods for war as any living American. He has had a long experience. A graduate engineer of the Carnegie Institute of Technology, he took his first job with the Westinghouse Electric Company at the magnificent rate of eighteen cents an hour. Tediously, arduously he has worked his way through all of the labyrinths of American industry, up to the position of the chief executive of General Motors where he had this extraordinary experience in the manufacture of the goods that are necessary to win wars.

But since World War I he has been intensely interested in dual plants—plants capable of producing the things that are necessary to satisfy the ambitions and the desires of man in peace and things necessary to equip man to defend himself against acts of aggression. There is probably no person in this country who has had the experience in this respect more than has Mr. Wilson.

He is a honorary graduate of Columbia University, and it is a great honor for me to be able to welcome him back to one of these appendages of the University of which he is an adopted son. Mr. Wilson!

THE ENIGMA OF THE TWENTIETH CENTURY

THE HONORABLE CHARLES E. WILSON
Secretary of Defense

MR. DOUGLAS, Honored Guests, Members of the Academy of Political Science, Ladies and Gentlemen:

The enigma of the twentieth century—the illusive, as yet unsolved, number one problem of our times—is how to achieve durable peace after winning victory in war. No nation or group of nations victorious in general war in the twentieth century has yet been able to work out a plan or formula for establishing and maintaining world peace even after military victory.

If as a nation we were drifting along taking the easy way, as we were before Korea only three and one-half years ago, oblivious of danger like an ostrich with its head in the sand, with a defense budget of only $13 billion and with less than one and one-half million men under arms, then I would not be here today talking about this important subject.

But the American people find themselves today in an unparalleled position in their history—neither at war nor at peace. With military spending about three and one-half times what it was before Korea and with more than three and one-half million men and women in our armed forces, our nation today is maintaining the largest peacetime military force in our history because of the ever-present threat of war.

We have appropriated hundreds of billions of dollars to rearm ourselves and our allies. Believing we must be prepared for the horrible eventuality of war, we are spending at a rate that would eliminate our entire national debt in a period of only six years if the same money currently being spent for defense could be used for debt reduction. Americans are willing and ready to do this for themselves and their allies because they realize the value of freedom and are determined to preserve it. At the same time they abhor war and cherish and hope for a state of peace.

This situation highlights what for me is the real enigma of the twentieth century.

The people of all nations want peace, not war. But their political leaders, statesmen, philosophers and thought leaders

generally have not been able to identify and gain general acceptance of the fundamentals of a durable peace. The settlements after these twentieth-century wars seem to have had within them the seeds of future wars rather than the foundations for permanent peace. Perhaps part of the difficulty is that the people themselves do not understand that to establish a durable peace requires effort and sacrifices somewhat comparable to what it takes to prepare for and win a general war.

The formula for avoiding a third world war, or even establishing world peace after such a war, is dimly sensed but still remains to be discovered. What I am proposing here tonight is that men of good will throughout the world devote an increasing amount of their time and effort to identifying the fundamentals of a lasting world peace, and that their political leaders start now to put such policies into effect in the hope that, by doing the kind of things that would be necessary to establish world peace after another world war, the world war itself would be averted.

All of us here this evening have witnessed the disillusionment that followed victory in two world wars. After World War I we promptly disbanded a powerful military organization on the assumption that the world was now safe for democracy. After World War II we promptly demobilized the most powerful military organization known to the world under the false assumption that aggression had been stopped and the evil designs of totalitarian dictators thwarted. In both cases we shortly found from bitter experience that wars to end wars were failures. The wars had not solved any of the world's fundamental problems nor perhaps had even relieved any of the pressures that either directly or indirectly had resulted in the wars. The shooting in Korea has now stopped, for which we all are thankful, but a satisfactory peace there remains to be established.

The United States in these troublesome and uncertain times finds itself in a position of tremendous responsibility. Since the attempt to lay the foundation for a durable peace following World War II at least in part has been a failure, and since the free world faces the threat of militant communism, the United States and the rest of the free world must be and continue to be prepared for possible war. Nevertheless, the clear purpose of the United States is to do everything that can be done to avoid war and establish peace.

In his speech of April 16, 1953, President Eisenhower pointed out that the way chosen by the United States was plainly marked by a few clear precepts which govern its conduct in world affairs.

First: No people on earth can be held—as a people—to be an enemy, for all humanity shares the common hunger for peace and fellowship and justice.

Second: No nation's security and well-being can be lastingly achieved in isolation, but only in effective coöperation with fellow nations.

Third: Any nation's right to a form of government and an economic system of its own choosing is inalienable.

Fourth: Any nation's attempt to dictate to other nations their form of government is indefensible.

Fifth: A nation's hope of lasting peace cannot be firmly based upon any race in armaments, but rather upon just relations and honest understanding with all other nations.

In ancient times wars were largely limited by the difficulties of transportation and communication. The victor had a very simple formula for treating his enemy: he either killed or enslaved all the able-bodied men; the women and children were likewise captured and enslaved; and all portable property was stolen. This formula, in ancient times, did permanently settle some of the bitter controversies, since the loser was practically annihilated.

Modern civilized nations have repudiated such cruel and barbarous procedures, although it does look as if some nations in recent wars have turned back the clock hundreds of years. Under modern conditions, with rapid transportation and long-distance communications, large areas and large populations become involved, and all elements of the population suffer as a result of war. Thus, the cost of a modern war in blood and treasure is so great that the victor loses along with the vanquished. In addition, the victor now does not know what to do with the vanquished. From this experience there is no reason to believe that victory in a third world war would alone lay the foundation for a permanent peace.

What can modern and civilized nations do to avoid terrible and almost annihilating wars and establish permanent peace in the world? Since victory alone in a third world war cannot be expected to lay the foundation for a permanent peace, other means must be found. There is an added reason why the road

to war as a solution should not be taken. It is that in the past the final wars between two great Powers have always ultimately been fatal for both. In ancient times when two of the great world Powers built up to a final devastating war, along with victory went the seeds of ultimate decay for the victor. Arnold J. Toynbee, the British historian, counts twenty-one times when such disastrous wars occurred. For this reason it is well to realize that a third world war would not settle the world's problems but would likely be fatal for the victor as well as the vanquished, unless it can be shown that in recent decades something new has been added—that some new and important factors have come into the situation, both for preventing war and for establishing a durable peace.

If the United States and Russia follow the pattern that Assyria did against Babylon, Sparta did against Athens, and Carthage did against Rome, and no new fundamental factors are involved, then it would be easy to predict the history of the next fifty or one hundred years. Sooner or later there would be another titanic collision with great destruction of life and property and of the modern world as we know it. In ancient times land areas were principally involved, and the wars did not importantly change the productivity of the land. But a third world war in our industrial age would be something entirely different. In many ways it would be more terrible than any of the wars of the past, for much of the productive property would be destroyed. This would take away the means of livelihood from many millions of people who then could be supported neither in the cities nor by primitive living on the land.

Many thoughtful people conclude that such a war is inevitable, judged by the record of history and their own recent observations. I happen to think that the situation is not so hopeless; since I believe that important new developments have taken place in relatively recent times which, if properly understood and made use of, can avoid such a disaster. It is my hope that America in its present position of world leadership will not suffer the fate of leading nations in the past, but will avoid this fate. This hope is based upon what I believe to be three new developments or discoveries.

The first of these is in the field of political and human rights. This great development, while it resulted from seed which was

sown much earlier in other parts of the world, had its real beginnings in the latter part of the eighteenth century, and it has had a profound and continuing influence on the whole world ever since. It has perhaps had its greatest development and fruition in our country. It has resulted in the recognition of the essential dignity and the inherent importance of the individual and his inalienable personal rights. It is upon this principle that the founders of our country developed our whole structure of government which was established specifically to promote the welfare of all the citizens rather than the aggrandizement of the state or the rulers thereof or of any small, privileged class.

In the declaration of principles which made possible the United States of America this great discovery of principle was recognized in the words "to secure these rights governments are instituted." The rights referred to are life, liberty and the pursuit of happiness—individual rights that are above and beyond any rights which may be conferred upon a business corporation, a labor union, a religious sect, a political party or any other group. The Constitution of our country was designed in part to protect the citizens against any attempt, even by the government itself, to invade these inalienable rights. In the 175 years that have passed since our country was founded, similar progress has been made in the nations of the free world where this same great principle is recognized.

One hundred years ago freedom had so recently emerged from centuries of tyranny that the educators, statesmen, inventors, scientists and business men had not had much opportunity to dream and plan for the betterment of the human race. The political systems of most nations were still promoting the arbitrary rule of the few and restricting the free initiative of the millions. This great development in the field of political and human rights has given millions of people personal freedom and has gone far toward fulfilling the age-old hopes and aspirations of mankind.

In recent years, and especially since the turn of the century, much progress has been made in the free world in developing a type of society which respects individual human rights. Our country in particular has a unique opportunity to establish leadership in this regard. To the extent that we stick to this ideal of a free society, a new and potent influence will exist in

the world. Based on this principle it is possible to work out plans which will contribute to personal security and the stability and peace of the world.

The second new and important factor that I believe has been added in recent years is our great discoveries in the field of science and the resultant development and use of mechanical horsepower and machines to decrease man's physical burdens and raise his standard of living. While the development of machines and mechanical horsepower is perhaps the most dramatic evidence of this new factor, many other important developments went along with it, such as an entirely new approach to analyzing and treating the ills of human beings, great improvements in agriculture and the food supply, and an ever-expanding knowledge of chemistry which has given us many new synthetic products. New frontiers in all these areas are being discovered almost daily. Material science now has the clear possibility and promise of the systematic utilization of all the natural resources of the earth for the good of the whole human race.

For centuries wars occurred through a clash of tribes and nations in their efforts to improve their food supply and welfare by extending the land area over which they had control. The development of mechanical horsepower, of machines and of the scientific method means that we now have a new kind of frontier which to a great degree is independent of land area. This enables people to increase their food supply and well-being without taking physical territory from their neighbors. The possibility of using this new scientific knowledge to improve the well-being of all the peoples of the earth and thus reduce the causes of war has been realized only to a limited extent. To date this scientific and technical knowledge has been used more to develop weapons of war than to develop means for preserving the peace. I am sure that maintaining and improving the standard of living of all the peoples of the earth through the increasing use of mechanical horsepower and the scientific approach now comprise one of the keys to peace in the world.

A third hopeful factor which has come into the picture is indicated by America's efforts, after both wars, to rehabilitate the economies of the defeated nations and restore their productivity and well-being. The hopeful implications of this policy are becoming increasingly well understood.

Beginning in the fifteenth and continuing through the nineteenth century the nations of Europe in varying degree depended upon a policy of colonialism to support the people in the home countries. Controversy over land areas at times was the cause for war. The nations that controlled colonies controlled not only the people who lived in them but their resources. The colonies provided a market for the goods from the mother country in return for the food and raw materials produced by the colonies. Colonialism was always more popular in the mother countries than in the colonies themselves. The colonies insisted on growing up politically, but this in itself often did not upset the fundamental economic relations between the countries.

Our country now has a policy that might even be called colonialism in reverse. We are now using a significant part of our time, money and resources for the benefit of other peoples, all in the hope of contributing to peace and stability. This is certainly a new development in the history of the world and indicates that the people of our country are beginning to understand that sacrifices are necessary in some areas to promote and maintain world peace, even as much greater sacrifices are necessary to win a war. This policy, of course, has its limitations, and this is the reason why it is so important for other countries in the free world to understand the basis for American productivity and through this understanding be inspired to improve their own productivity rapidly. It should become increasingly clear to the peoples of the world that Americans have no desire to expand their area of influence in the pattern of the old colonial empires or to gain for themselves by holding down the living standard of other peoples. The truth is, we Americans consider that our future progress to a large degree will depend upon the progress which other nations make at the same time. We believe that the greatest progress for each nation can be made only when all nations make progress in freely developing their resources and thus the world's, and we are willing to help with time, money and effort.

As long as militant communism continues to be a threat to the peace of the free world we must continue to be strong in both a military and economic sense. We cannot depend on arms and arms alone as the basis for peace abroad and freedom at home. While keeping strong in a military sense to deter aggres-

sion and insure final victory in case of war, to win a durable peace we must make progress in eliminating the causes of war and put into effect the policies that will contribute to a stable peace.

The peoples of all nations wish to avoid war and see world peace established. At the same time they wish to improve their personal security and standard of living. The United Nations was founded in recognition of these impelling desires. Fully conscious of the moral and spiritual issues involved, political leaders and men of good will throughout the world should cooperate in the effort to identify the sound policies and methods that will have to be adopted to achieve these objectives.

We must take the lead in showing others how to accomplish these ends and assist them in every way we can in their efforts in this direction. Among the policies that must be subscribed to by all nations to bring the world's economic productivity to the highest possible level are freer exchange of technical knowledge and production "know-how", freer access to raw materials in a world market including the active development of natural resources throughout the world, freer exchange of goods and services, and the gradual elimination of artificial and political trade barriers. Real progress must also be made in strengthening the economies of all nations and raising their standard of living through a better understanding of the relationships between the production and consumption of goods and services, and between exports and imports, credit and debt, trade barriers and the money supply.

These policies are essential to the establishment of a durable peace. They are based upon and made possible by the three new developments of relatively recent times to which I have called attention. They are consistent with the precepts which President Eisenhower enunciated in his speech of April 16 as the basis of our foreign policy.

The responsibility of the Department of Defense is to see to it that our military strength is sufficient to resist aggression and prove a strong deterrent to war. We must be prepared to carry out such military missions as the Congress, the President, and the American people decide to be necessary. In carrying out these very important responsibilities we are ever mindful of the great cost and futility of war. I realize we must also strive to figure out what it takes to win peace even after war, and, by putting those policies into effect now, help avert war.

It is my hope and prayer that the nations of the free world through following this pattern will solve the enigma of the twentieth century and, even at this late date, avoid another disastrous war.

Remarks by the Chairman

President Douglas: Mr. Secretary, we are grateful to you indeed for delivering this address.

We appreciate the horizon of discussion which you have opened up. You have, I think, raised the question—and it is the riddle of our times—how can the victors in war remain the victors in peace? And you have suggested that the best and perhaps the only answer is to avoid another great convulsion.

It is probably true that an examination of the last twenty years of human experience demonstrates beyond reasonable doubt or debate that modern war, which contemplates the complete organization of society for the purpose of exercising devastating power, is the most revolutionary device man has yet devised. And how society, organized around the responsibility of the individual and the free market place as the arbiter of economic affairs, can survive another great convulsion of this sort is indeed the riddle of our times. And the only effective answer to this riddle is how it can be avoided. But these social convulsions leave behind them, not trails of glory, but trails of devastation and desolation in a lacerated society from which men and women do not recover in the course of several generations. This is the riddle—the enigma—of our times.

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